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The Internal AUDITOR

JOURNAL OF THE INSTITUTE OF INTERNAL AUDITORS

SEPTEMBER 1957

THE AUDITING OF ADVERTISING AND SALES PROMOTION EXPENSE — F. W. LENNON

AUDITING THE GENERAL ACCOUNTING ACTIVITY — E. B. MURRAY

ORGANIZATION AND FUNCTION OF INTERNAL AUDITING IN A MAJOR OIL PRODUCING COMPANY — M. E. PRICE

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The Internal Auditor

JOURNAL OF
THE INSTITUTE OF INTERNAL AUDITORS

VOL. 14 SEPTEMBER, 1957 NO. 3

THE PRESIDENT'S PAGE

THE Sixteenth Annual Conference at Los Angeles is now a very pleasant memory. But more than that I like to look upon it as another milestone along the way of maturity of our INSTITUTE. The returns are not all in, but we know now that one of our most successful conferences has been achieved in the Far West, an achievement heretofore not thought possible by many of us. From now on provincialism is definitely eliminated from THE INSTITUTE picture.

Of course, there are other aspects of maturity as well as of wide-spread membership distribution. There are definite signs that we are coming of age as a profession, as well as an organization, when we see an ever-increasing number of our members engaging in an ever-broadening audit program in their companies. In this respect, the recently revised "Statement of Responsibilities" might very well be used as a benchmark for all of our members to constantly appraise their professional progress.

Another aspect of maturity is the extent to which we all achieve an increasing and permanent acceptance in the 2,000 companies we presently serve. Management's acceptance of an ever-broadening audit scope is something to be constantly striven for; but once attained, we owe it to our companies, our profession, and ourselves, that we do not backslide into a lesser position. Our progress must be earned, bit by bit, and if every member not only gains more recognition in his own company and retains these gains, then the over-all progress of THE INSTITUTE will be assured.

W. R. DAVIES

A REVISED STATEMENT OF RESPONSIBILITIES

The development of the original Statement of Responsibilities of the Internal Auditor was one of the early research projects of THE INSTITUTE. After prolonged consideration and suggestion, this first Statement was approved by the Board of Directors of THE INSTITUTE on July 15, 1947. One of the indicators of interest and acceptance was the distribution of over 20,000 copies in 10 years.

After the original Statement was issued, the concepts and practice of internal auditing continued to advance—particularly in the extension of internal auditing in the operating departments of business. This trend developed to a point that it became necessary to revise the Statement in order that it might—as in the past—define and guide thinking as to the responsibilities of today.

The work of revision required the securing and coordination of the ideas of members, chapters and leaders in the internal auditing field. This was undertaken by Arthur H. Kent, Chairman of THE INSTITUTE'S Research Committee, who did a masterly piece of work of assembly, reconciliation and evaluation of many often-differing viewpoints.

The result is the revised Statement of Responsibilities, which was approved by THE INSTITUTE'S Board of Directors on May 30, 1957 and which is sent to you with this issue of THE INTERNAL AUDITOR. Like the earlier statement at the time of its issue, the present statement presents an advanced conception of the nature, scope and responsibility of the internal auditor's work.

Additional copies may be secured upon request to THE INSTITUTE office.

THE AUDITING OF ADVERTISING AND SALES PROMOTION EXPENSE*

By FRANK W. LENNON
General Auditor, Pure Oil Company

In a growing and healthy economy the manufacturer and merchandiser are constantly faced with the need for influencing the public to buy their products. The cost of this process of influencing amounted to some $10 billions in the U. S. A. in 1956. Is this money spent under adequate control, and is it spent economically? These are two important questions for the internal auditor to probe, and the philosophy and technique of this probing is discussed in this article.

IN a capitalistic system of economy where competitive forces are allowed free reign in their quest of the consumer's dollar, it is only the naive who believe that advertising and sales promotion activities do not play a dynamic part in the choice that an individual makes in preferring one product over another. To many people—advertising is a magic word—glamorous, mystical and romantic. However if we wished to express its objectives in a simple manner—we would say it is nothing more than means used for getting people in a favorable frame of mind to buy certain products or services—to get them to actually buy them—and—to keep them continually buying them in a highly competitive market in which our inventive genius knows no end in the development of substitutes.

In the year 1956 it was estimated that the total volume of advertising in the United States, both local and national, ran close to 10 billion dollars—about triple of that spent in 1946. And in 1966—ten years onward, it is estimated the total annual advertising bill will be in the neighborhood of 20 billion. The expected increase in expenditures for advertising appears to be a natural phenomenon in a country where its basic problem is one of consumption and not of production. Professor David M. Potter of Yale covered this point in his work "People of Plenty" when he stated, "In the economics of abundance, advertising begins to fulfill a really essential economic function. In this situation the producer knows that the limitation upon his opera-

* Delivered at the Midwest Regional Conference, THE INSTITUTE OF INTERNAL AUDITORS, Louisville, Ky.

tions and upon his growth no longer lies in his productive capacity, for he can always produce as much as the market will absorb. If this new productive capacity is to be used, the imperative must fall upon consumption, and the society must be adjusted to a new set of drives and values in which consumption is paramount."

So much for a preface on advertising in general—now let us consider the interest that we, as internal auditors, should have in this subject in the examination and appraisal of our company's records and operations. For most of us, I believe we will agree that the amounts being spent on advertising and sales promotion by our companies are relatively significant and therefore such functions should quite appropriately be included in the schedule of audit assignments. Having included this examination in our schedule, the question is—What type of audit program shall we follow to fully discharge our responsibility?

When I made a rather limited inquiry among some of my associates in THE INSTITUTE as to the program they were following, I found a vast dissimilarity of approach as well as a recognition that the programs that were being followed—including our own—possessed many gaps which, if covered, might disclose costly discrepancies or might result in initiating some profitable savings and changes.

In our work I am sure we will all agree that we cannot establish an audit program for the review of a particular function and think of such program as the "one and only"—for circumstances vary with individual assignments and our programs must be modified accordingly. I do believe however, as professional auditors, we should be somewhat in agreement as to the basic objectives in connection with the examination of any given function.

What might be considered the basic objectives in the audit of expenditures for advertising? Although they might be expressed in more scholarly terms, I believe the primary objectives are (1) to satisfy ourselves that adequate controls have been established to account for the advertising dollar spent, and, (2) to make sure that full consideration has been given to the many facets that might afford the same amount of advertising at less cost or an additional amount at the same cost. I do not believe it is within province of the internal auditor to express an opinion as to the over-all effectiveness of the advertising program. However, I certainly do not consider him off-

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FRANK W. LENNON *is General Auditor of The Pure Oil Company and has been associated with this company for the past twenty-two years. A graduate of the University of Illinois, Mr. Lennon taught at that institution, as well as DePaul University, and at present lectures in advanced accounting in the evening division at Northwestern University.*

Mr. Lennon served as the president of the Chicago Chapter of THE INSTITUTE *1951-52 and as International President 1955-56.*

base in making inquiries in the course of audit concerning the effectiveness of a particular part of an advertising or sales promotion program where he has reasonable grounds for doing so. And reasonable grounds in this instance certainly precludes anything that has a connotation of "hindsight" or "second guessing."

Advertising and sales promotion plans can be covered through many media and by schemes that are only listed by the wildest of imaginations. In this discussion I shall limit myself to some of the basic ones to illustrate an approach to what might be considered as an acceptable audit program.

The first managerial control that we normally encounter over advertising and sales promotion expenses is a budget that we would normally expect to evidence review and approval by a top executive of the company. This budget, or the underlying schedules that were used in its preparation, will usually be in such detail that it will reflect among many other things the amounts that have been allocated to various advertising media, broken down between that placed on a national basis and that on a local basis. It will also indicate the amounts to be spent on the individual sales promotion plans contemplated during the coming year.

In respect to the budget I question whether the internal auditor has any real responsibility. I believe the type of items he would be in a position to challenge would be insignificant in relation to the entire program. For example, in determining the total amount that management is willing to allocate to advertising, an article in a most recent issue of Fortune stated "that advertising expenditures are still governed basically by sales levels. Some advertisers still determine their advertising appropriation by mechanical formula. It remains a fixed percentage of sales, year after year. In recent years most of the major advertisers have gotten away from this mechanical approach to the problem. They figure their sales objectives for the coming years, then calculate the size of the appropriation to do the job. But, the difference between the fixed percentage technique and the sales objective technique is partly a semantic matter. For the objective—'The sales job that has to be done'—is itself largely an extension of current sales."

If we agree that the auditor could do very little in the determination of the total budget for advertising—excluding, of course, the influence his disclosures in the past may have had in establishing the budget—I do not believe he is qualified or that he should qualify himself to challenge the proposed plans the company intends to follow in the use of it.

In respect to the budget *I do* believe he has a direct responsibility to determine that the control over expenditures made is resulting in their being accounted for in a manner which will result in a true comparison

between amounts allocated in the budget under a given classification and that which was actually expended under that classification. And while we are on this particular subject, I hope that there are none who believe that those in our company who are responsible for advertising and sales promotion are to be commended primarily because the amounts spent during the year were less than that budgeted. Unlike other activities of the company, the basic purpose of the advertising and sales promotion function *is to spend* a certain sum of money to influence the action of people. Without discussing all the factors involved, I might say when I personally see an under-expenditure of advertising and sales promotion funds my first reaction is to consider it not in the light of a performance having been better than that budgeted, but, that the original estimate was in error or that circumstances have occurred during the period which should have resulted in a change in the original estimate. I mention this in passing, for there are some on initial audit assignments of this function who have been naive in thinking that under expenditure of budget amounts is prima facie evidence of good performance.

Some companies, in order to effect a closer control over advertising expenditures, have established a separate set of accounting records in which all expenditures for advertising and sales promotion are recorded. There is a question as to whether this manner of recording results in any appreciable increases in control over such expenditures. However, it does facilitate the auditing of these functions.

With an advertising budget of any size, management has probably made its decision regarding the matter of either exclusively using advertising agency services or performing its own advertising work—or using a combination of the two.

However, with the tremendous increase in the amount and cost of advertising, it has become increasingly difficult for both the publishers and advertisers to deal on a direct basis. As a result, the agency has come to a place of importance in the picture and has brought with it the advantages that come from specialization and diversification within a specialized field.

With respect to the use or non-use of an advertising agency by a company, it may be of interest to quote from the article in Fortune that has been previously referred to. "A little more than 40% of all advertising in the United States is accounted for by local retail stores. This does not mean it is economically inconsequential; however, it does not importantly affect what is usually thought of as 'the advertising business *i.e.* the agencies. The bulk of newspaper retail advertising, and large pieces of local radio, television, and billboard copy—come into this world unhallowed by any agency effort; the advertisers and media contrive to do the job themselves." And, while on

this subject, a recent consent decree, which I will discuss later, may influence more companies to handle their advertising on a direct basis rather than through an agency.

I do not believe it necessary to cover in detail the features of an audit program both under an arrangement where the company's advertising is handled through an agency and also where the company handles its own advertising work. Most of the general features discussed under one are identical with those that must be given consideration under the other. I have chosen to discuss an audit program where the advertising activities are handled through an agency.

When a company uses the services of an advertising agency, a contract is entered into specifying the services that will be rendered and the consideration. In many instances these agreements consist of nothing more than a series of letters between the principal parties concerned. An editorial that appeared in a recent issue of the Advertising Agency Magazine stated: "Agencies also are entering into more complete understandings with their clients through written contracts. It is apparent that the agencies which are very casual about this matter, either employing no contract or else only a simple letter of agreement are the exception. Most agencies want to be quite specific about their working relationships with their clients. It is not that the agency client relationship is more binding merely because of a written contract, for such agreements generally run for a year, with either party free to cancel upon 60 days' notice. The great virtue of the contract is that it obviates misunderstandings. Because of the contract, the client knows what to expect and the agency knows what it must deliver."

The first part of our audit program is for the internal auditor to familiarize himself with the terms of the contract and any special arrangements that might be covered by addendums.

The principal compensation received by any agency for handling a company's advertising is a discount of 15% allowed by each advertising medium. If this discount is not given by a particular medium, the contract with the agency usually provides for the advertiser (company) to pay the agency its net cost of procurement plus 15%. The 15% realized by the agency is to compensate it for the services that it renders under the contract. These services are spelled out in the agreement and cover areas dealing with such matters as a study of the company's markets, planning, creating and writing of all visual advertising, study and selection of media to be used, planning of campaigns, and handling all the mechanical detail involved in procuring and paying for medium space or time. A number of these services are expressed in such general terms that it is difficult at times to determine whether a specific service is included in the provision or whether it is something

extra—which usually for such extra service gives the agency the right under the contract to bill the company at its cost plus 15%. On this particular subject the October 1956 issue of Fortune, in the second of a series of articles on advertising agencies, had this to say—"There is no hard and fast rule about what comes free with the 15% commission, and what the client is expected to pay for—usually at cost plus 15%. Obviously there is plenty of room for maneuvering in this area, and to protect profit margins agencies have to hold down the amount of 'free' research and other services they provide. Indeed, clients sometimes complain about being shortchanged on such services. I know one agency—says a former agency executive—where the account supervisors are told that the amount of their bonus depends on the amount of 'free' research required on their accounts. The less research, the more bonus. On the other hand, the agencies themselves, in competing for clients have taught advertisers to expect a lot in the way of 'free service.'"

It is not unusual for the contract to provide that the agency will be guaranteed a minimum of commission earnings on the account. If this is not realized by the agency, the deficiency must be paid by the advertiser, *i.e.*, the company.

Before proceeding further with our program of audit, it may be desirable to discuss what is known as the "Estimate Sheets."

As a part of the development of an advertising program, it is a common practice for the advertising agency to work closely with the company, and to submit schedules showing the estimated cost of the program. Deference is given by the agency to the company as to the breakdown of the estimates, and usually they are in great detail—giving, among other things, the exact medium to be used, the time, and the cost based upon the latest published rates of the various media. The final estimate sheets are approved by the company management, and should, of course, tie in with budgetary allocations. These sheets are quite frequently used as a control feature in connection with actual expenditures.

With this as a background, how will we proceed to accomplish one of our main audit objectives, that is, to satisfy ourselves that adequate controls have been established to account for the advertising dollar spent? The controls will basically have to accomplish the following:

1. To determine that the price paid is correct.
2. To determine that the services have actually been rendered.
3. To determine that proper accounting distribution has been made of the expenditure.

To determine that the proper price has been paid, rates can be checked against the "Standard Rate and Data Service," a published record of stand-

ard rates and discounts of magazines, newspapers, and radio and television networks.

The uninitiated would believe that the verification of these rates against the service would be a simple process—but this is far from the case. Many complex problems arise in the application of rates and discounts due to variations because of the number of insertions, the number of lines of space in a certain period, the location within the media, and whether the item is in black and white or color. With regard to radio and television time, the number of weeks the program is on the air, and whether or not the summer months are used are factors, and spot announcement rates will vary with the number of times on the air within a specified period and with the particular time during the day the announcements are made. Outdoor advertising rates can be checked against those published by the National Outdoor Advertising Bureau.

The second feature of control is the determination that the services billed have been rendered. For newspaper and other publications, tear sheets can be obtained and used for this purpose. For television and radio programs the stations usually submit with their invoices affidavits or certifications to the effect that the time billed has actually been used on behalf of the company. On large television network programs it is not unusual for the advertising agency to have a representative present whose vital concern, I understand, is to make sure that the commercials are properly presented. In outdoor advertising the controls set-up to determine that the work has been done consist primarily of a certain amount of inspection by advertising agencies, investigations made by the National Outdoor Advertising Bureau, and a certain amount of responsibility being placed with the company's local sales organization to check performance in their area.

In the review of controls over rates and prices that are charged and whether the services have been performed—an important question may be posed—and that is—when a company's advertising is placed through an agency, should controls be established within the company to check these phases or can the company rely solely upon the agency to perform these functions? In my study of this subject I found one company that relied practically 100% on the agency to perform these verifications. This particular company evidenced a very strong feeling regarding the agency's integrity, and felt that if the agency's program was to verify billings made to it by the various media against the published rates and that it ascertained in the usual manner that the services were performed, it saw no reason why this effort should be duplicated by the company. This company also felt that these services were a part of the normal ones it could expect for the fees the agency received. At first blush one might wholly condemn such a

practice. However, on further consideration it is possible that we might conclude that this position has some merit. I have not completely resolved this matter in my own mind, but am of the opinion that if the practice is followed of relying solely on the agency for verifications, then the internal audit program should include a review of the agency's records to determine that adequate control procedures have been established within the organization and that the controls are operating satisfactorily. Let us recognize that the right to review the agency's records is usually contained in practically all agency agreements.

Having covered the first basic objective of our examination, namely that adequate controls have been established to account for the advertising dollar spent, let us now consider some of the areas that might be reviewed by the internal auditor in accomplishing the second objective of our examination, which is to make sure that full consideration has been given to the many facets that might afford the same amount of advertising and services at less cost or an additional amount at practically the same cost. In accomplishing this objective the internal auditor could give consideration to several areas including the following—

1. Determine whether proper consideration is being given to rate structure whereby a nominal increase in the amount of space in a certain magazine or paper, or additional time on radio or television, may place the advertising in a lower rate bracket and result in a substantial reduction in cost.
2. If there exists within a company a decentralized control over advertising expense, some method of handling should be established for the company to enjoy the full benefits of volume rates and discounts on its total advertising.
3. Some organizations have been able to affect substantial savings by revising and improving their reference file on all advertising and sales promotion work. These files, if maintained efficiently, have been able to provide for the re-use of art work and thus eliminate the necessity for placing new orders.
4. On work placed on the outside either by the company or through an agency questions might be raised concerning the feasibility of the company doing the work itself. For example, a firm at one time may have decided to send its photostat work outside, but, due to changing conditions and an increase in volume, it may be advisable for it to acquire its own photostating equipment or search for a more economical way to produce the material required.
5. Concerning the point discussed regarding photostats or other services—the big question that might be raised today is—Why doesn't a

company place its advertising direct and not through an agency? Until recently there would have been no particular advantage, rather a disadvantage, in doing this as the company would still have to pay the published rates to the media and it would not enjoy the many specialized services performed "free of charge" by the agency. However, just recently a consent decree was processed through the courts whereby it may be possible for a company to set up its own agency to handle its account alone and receive the 15% discount of published rates now enjoyed by the regular agencies. Whether this consent decree will result in big advertisers establishing their own agencies remains to be seen.

* * *

The internal auditor must also consider his responsibilities for auditing sales promotion expenditures. Where advertising stops and sales promotion begins is a good question for a quiz program. However, it is not paramount to the issue at hand. Whether a particular activity is classified by our companies as one or the other has very little bearing on the program we might follow in the review of this function.

Excluding advertising through radio, television, newspapers, magazines and 24 sheet posters, there are hundreds of other merchandising aids employed for promoting sales. Some are quite unique; others are somewhat universal. In our audit of these various types of merchandising aids our objectives will be basically the same as for advertising expenditures. However, our program of audit will be at least modified by the fact that most of the sales promotion plans have physical materials and merchandise to be accounted for.

Merchandising aids, among many others, can include dealer literature, sales and service manuals, product manuals, coupon deals, merchandising premiums, and all kinds of sales promotion material.

To audit any of these merchandising activities *the internal auditor must fully acquaint himself* with the objectives and purposes of the program, and of the mechanical means that have been set up for its accomplishment. The reminder of such a requirement may seem naive, but too frequently on audit assignments that go beyond the verification of account balances and financial data, the auditor will start to develop his program before he has sufficient facts concerning the operation of the activity being reviewed.

Sales promotion material covers many types of items and printed matter that are sent to dealers and to prospective purchasers. Among other things, it will consist of counter and window displays, floor stands, catalogs, price lists, circulars, envelope enclosures, banners, novelties and gifts.

In our endeavor to audit the controls that have been set up for these expenditures, we must recognize certain physical and psychological factors in accounting for this type of material. We must recognize that no set pattern can be established for control because of the great variety of materials that are used and the numerous methods of distribution that are followed. We should also recognize that the cost of the material is ordinarily charged to expense immediately, that it is generally given away free, and consequently, those handling it will be inclined to consider it of little monetary value. These foregoing and other factors often lead to an indiscriminate distribution of the material by the sales organization, as well as a lack of appreciation for its proper storage and accountability. In Cadmus and Child's book on "Internal Control Against Fraud and Waste" the authors state that in a survey made by an advertising agency the results indicated that approximately 70% of sales promotion material was wasted.

In our audit programs of this type of expenditure we should concern ourselves with the following factors:

1. That proper procedures and controls have been established for ordering, receiving and paying for material that we would normally expect for any other type of material and merchandise.
2. That proper consideration is given to quantities purchased as related to the proposed distribution.
3. That the methods of distribution result in a more economic handling and shipping of the items.
4. That adequate storage facilities are provided and are satisfactorily maintained for items ordered in large quantities to be distributed over a relatively extended period of time.
5. That, where a charge is to be made to the dealer or customer for the material, that proper controls have been established to insure that the charges are made, and that collections are being properly handled. (In transactions of this nature I am inclined to believe our controls may be found to be inadequate, or at least, not of the best.)

And now in conclusion I would like to leave with you these general observations. Those engaged in advertising and sales promotion activities are primarily concerned with the creation and development of ideas and plans that will result in increased sales of their company's products and services. They give very little thought to control features involved over monies spent which have previously been authorized and approved through their budget by top management. This is not unnatural, and I can fully appreciate that, in this area of operations, we may find a greater resistance or reluctance on the part of those concerned to establish even what might be considered minimum control requirements. However, in admitting a

difficulty, let us not admit defeat. If we in internal auditing approach this problem completely devoid of any narrow connotations, our ideas will be given proper consideration by those responsible for this selling function.

Many of us are not giving due consideration to this function in our schedule of assignments; and if we are, the program of audit consists of little more than a verification that payments are supported by invoices, that the proper account is charged, and that the amount spent is not in excess of the budgeted allocation.

A lack of audit and a weak audit are both lamentable. My sincere hope is that the few things that I have discussed with you in this paper will encourage the initiated and the uninitiated to do a better job in an area that is fertile for some good internal auditing.

AUDITING THE GENERAL ACCOUNTING ACTIVITY*

By EDWARDS B. MURRAY

Manager, Auditing Department, General Electric Company

The author examines the underlying motives and principles of five fundamental techniques in auditing. He illustrates them with useful case studies. This article deserves the careful attention of the practicing internal auditor, whose familiarity with these techniques may sometime influence him to over-look their inherent values.

INTRODUCTION

THE term "general accounting" is an elastic one which is subject to varying interpretation dependent upon its organizational environment. It is, therefore, difficult to define the boundaries of the subject matter with which this discussion is concerned. An audit in depth of the general accounting activity may extend into the farthest reaches of a business operation and into every aspect of the accounting and financial function. We might arbitrarily limit our discussion to that portion of the internal audit work which is customarily performed outside the factory, but we would quickly come to the conclusion that neither the audit of the general accounts nor the examination of factory accounts can be safely compartmentalized and successfully pursued independently of the other.

The full value of internal audit can be realized only if the auditor has freedom to carry his investigations in any direction in which they may logically lead. The ideal object of audit would be a complete business unit, preferably a self-contained one, operating under its own corporate or decentralized management and one small enough for a small crew of auditors to cover in a reasonable period of time. The internal auditor seldom encounters an ideal organizational situation from an audit standpoint and must, therefore, be able to deal effectively with part of the business unit and to adapt his procedures to his assignment, however restricted or broad. For convenience we will exclude from consideration the specialized areas of procurement, costs and inventories. However, it will become evident that the

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approach and principles which we will discuss are applicable to these areas as well as those more closely related to general accounting.

Before entering upon a discussion of audit principles, it may be useful to state the premises upon which this discussion is based. First, the general objectives of an internal audit of a business component must be agreed upon. A fairly comprehensive list might well contain four points:

1. Verification of the principal financial statements of the component or company, either as an objective in itself or as incidental to the main purpose of assuring management that the figures upon which they must rely to control the enterprise are meaningful and accurate.
2. Examination of control procedures to determine that they are adequate and are being carefully followed. The examination will necessarily be directed toward exposure of any fraud, irregularity or wasteful practice of substantial amount or recurring nature and will consider the means of closing the door to recurrence of such conditions.
3. Attention to the efficiency and economy of operation to the extent that this comes within the purview of the financial function or comes to the auditor's attention in the course of his work, and
4. Determination that company accounting, financial and other policies, rules and regulations are being observed.

I do not intend to imply that this is an all-inclusive list, or that every audit will necessarily cover all these objectives. However, most normal internal audit programs should be directed toward some combination of these four audit goals.

Having assumed this set of objectives, we can proceed to examine a few basic principles. I consider the five most important precepts, principles or rules for the successful and productive internal audit to be: (1) intelligent selection of items and transactions for audit, (2) a dual audit approach by analysis and checking, (3) examination in depth and insistence on corroboration, (4) intelligent programming, leaving room for individual discretion and ingenuity, and (5) independence and integrity of opinion and criticism and the clear and accurate reporting of such opinion and criticism. Let us look at each of these precepts in its relationship to the general audit or the audit of the general accounting activity.

SELECTION

Perhaps the best way of illustrating the need for careful and thoughtful selection of items for sampling is to mention a homely but horrible example of what can happen if inadequate thought and attention are given to selection.

The case concerned involved a cashier who sought to supplement his regular salary with modest but persistent filchings from his employer's funds. He first tested the adequacy of existing control procedures by minor alterations of the totals of several vouchers submitted for reimbursement. Having thus assured himself that no one was checking the footings of these reimbursing vouchers he proceeded to inflate enough vouchers to yield the desired "profit" each month. The only fly in the ointment was the annual visit of the auditor. However, this was only a minor hazard, since the auditor appeared at precisely the same time each year and invariably limited his tests to the petty cash transactions for the preceding three months. So for nine months of each year the cashier carried on his private profit-sharing arrangement and for the last three months of each audit period the petty cash transactions were kept scrupulously clean. After several years of success the cashier's castles crumbled when a young auditor had the temerity to question the hallowed procedures of his predecessors and to test the reimbursing vouchers for the early part of the year instead of the last quarter.

The total effectiveness of an audit can be materially influenced by this simple matter of selection. The criteria upon which selection is based will vary under varying conditions and for various phases of the audit work. It can be dangerous to specify a hard and fast set of rules for selection in the audit program, since no uniform formula can take into consideration all possible situations, and the existence of a set of rules may discourage the proper exercise of individual judgment and initiative on the part of the auditor. Among the considerations which may govern the selection in any individual case are:

1. Coverage of the greatest possible dollar value of assets, liabilities or operating transactions with examination of the fewest possible items or transactions
2. Avoidance of a predictable pattern of selection as to types of transactions, values, periods of time or other identifiable criteria
3. Likelihood of fraud or error.

I am sure that most auditors have at one time or another been given the facetious advice not to waste time auditing the things that are right but just to look at those that are wrong. This advice isn't quite as foolish as it sounds.

EDWARDS B. MURRAY *was born in Anderson, S. C. Graduated from Hughes High School, Cincinnati, Ohio, in 1931 and received an A.B. Degree from Princeton University in 1935. Has been employed by the General Electric Company since 1935 being promoted from Traveling Auditor to Supervising Auditor and then Chief Traveling Auditor and member of the staff of Assistant Comptroller. In 1953 was raised to Manager of the Auditing Department, a position which he still holds. He is a member of* THE INSTITUTE OF INTERNAL AUDITORS *and The Controllers Institute of America.*

We have all seen auditors who seem to have a nose for error or irregularity, auditors who can "smell" misappropriations, errors and waste of money. We are inclined to pass off such cases as unexplainable talent or instinct. A little closer examination, however, seems to indicate that these extraordinary gifted auditors are endowed with neither supersensitive olfactory senses nor the homing instinct of fish or fowl. They are merely using their normal complement of brains on a full-time basis. While they cannot select only "wrong" transactions to audit, they can and do quickly abandon those which are right and quickly expand and re-route their examination of those which logic indicates can lead to important disclosures.

As an example of this type of alertness, the disclosure of a misappropriation of more than $10,000 came about from the thorough and exhaustive examination of a single bill in the amount of $40.57. This was one of many thousands of customer bills under examination and one of insignificance from a dollar standpoint. However, in flipping past this bill the auditor noticed an unusual alteration in the section of the invoice devoted to shipping data. The invoice was marked "cancelled" and the combination of this with the alteration of shipping data was enough to divert the auditor from further examination of bills and to direct his attention toward a full explanation of this one small invoice. A quick check with the customer indicated that the material covered by the cancelled invoice had been delivered and paid for. Several weeks of concentrated work stemming from this one transaction culminated in confessions by five employees who had devised a scheme of collusive theft and concealment by alteration of records which was practically foolproof.

No discussion of selection can be up to date without at least a mention of statistical sampling techniques. The audit of a statistically homogeneous population of financial transactions can become more meaningful and less costly if the mathematics of statistics are applied judiciously. The great advantage of the statistical approach is that it permits the auditor to evaluate the risks he is assuming and to measure objectively the effectiveness and quality of detailed accounting work. Without this approach, it is too easy to base our evaluation of accounting work upon impressions, personalities, prejudice based on prior reputation and other intangible factors. I imagine most of us have encountered instances in which a few errors and inaccuracies did not seem too important because the man in charge of the work seemed to be a pleasant and cooperative person. On the other hand, there may be a tendency to be hypercritical of even small transgressions on the part of an individual who is personally obnoxious. I do not mean to imply that a full evaluation of performance should not include the intangibles as well as the tangible factors; however, the statistical sampling approach does help to place the tangible factors in proper perspective.

Mathematical techniques are useful but are never a substitute for good business judgment. They should not be permitted to become a crutch to the auditor or to excuse him from exercising his imagination, initiative and discretion. Internal auditors must be responsive to all possibilities of improving the effectiveness of their work, but they must also remain aware of their basic responsibilities and tread cautiously along any untried procedural paths, however bright the prospects of accomplishment may appear.

DUAL APPROACH

Perhaps the principle of dual audit appoach is so commonplace and so obvious that it requires little discussion. Most comprehensive internal audit programs incorporate this method in one form or another; however, I am not sure that every internal auditor has taken the time to examine the basic reasons behind the standard audit program procedures.

To insure a common understanding, what I have called a dual audit approach represents: first, *analysis* of the general ledger accounts and the tracing of selected entries and transactions from that analysis back to their source; and secondly, the *checking* of source transactions of similar nature and tracing of the summarization and entry of these transactions into the general accounts. The dual audit approach starts at both ends, with the financial statements and with the source data, and works toward the other end. Neither the analysis method nor the checking method is completely effective in itself. For instance, a single irregular payment of substantial amount may be quickly pinpointed by analysis and examination of unusual entries to the general ledger accounts. It would be a matter of pure luck to find this item through the checking approach, that is, by examination of all payments for a test period. On the other hand, repetitive irregular or fraudulent payments of relatively small individual amounts can be brought to light by thorough examination of all payments for a selected period, regardless of size or accounting distribution, although the size and consistency of the payments might make it highly improbable that they would be detected by analysis of the general ledger. The checking method, of course, can be part and parcel of the examination of control procedures. The best possible way of checking out the accounts payable routine is to examine all voucher payments for a period of a month. Controls over cash receipts, billing and payrolls can also best be tested by the checking of original data *toward* the general ledger. On the other hand, the analysis method is essential to verification of the balance sheet and certification of the financial statements. It is clear that analysis and checking are complementary rather than conflicting approaches and are inseparably combined in any complete audit program.

EXAMINATION IN DEPTH

While in many respects the internal auditor must model his techniques, programs and standards upon those of the public accounting profession, and he is indeed fortunate in having the high standards of a kindred profession for a model, he must none-the-less recognize that his function differs from that of the public accountant. While it is dangerous to generalize, it is usually recognized that his work must be in greater detail and in greater depth than that generally required of the public accountant. The public accountant seeks to develop and express an informed opinion on the financial statements based on reasonable evidence. He is interested in the system of internal controls as an aid in judging the reliability of evidence. However, the internal audit staff represents, in itself, one of the major internal controls, and if the public accountant finds the internal audit program and work satisfactory, he does not need to penetrate beyond reasonable evidence or to offer conclusive assurance that operating procedures are being carried out efficiently and effectively and that the assets of the business have been thoroughly protected against possible loss or wastage. These are the functions of internal audit.

As an example in the area of payrolls, the public accountant may reasonably rely on properly processed documents such as cancelled checks, time cards, piecework vouchers and rate authorizations to support an opinion with respect to payment of, and accounting for, payroll disbursements. The internal auditor must go beyond such reasonable evidence and seek corroboration by any means at his disposal. Time records may be proved by test payoffs or observation of employees at work. Piecework vouchers may be confirmed by comparison with production, inventory and shipping records or by physical counts and observation. Pay rates may be checked with job evaluations or time studies and these in turn by observation of the work actually performed. He must be interested not only in the propriety of payments but also in the value received by his company for the payments. He must recognize that a document is a piece of paper created in the business process and is only as good as the knowledge, integrity and accuracy of its creators. He must accept as fact only what he can confirm independently.

This search for corroboration does not mean that the auditor must distrust everybody until proven innocent. It is more than stubborn insistence on proof. Rather it is the avenue to fulfillment of the prime purpose for which internal auditing exists. This type of examination in depth provides an orderly approach to critical review of those business operations and procedures which are directly related to the dollars and cents received and expended by the business. In the course of giving his management full assurance that the assets of the business are being properly safeguarded, the

auditor is automatically exposed to opportunities for direct and substantial contribution to profitable operation. The extent of his contribution will be proportional to the alertness, initiative and imagination that he brings to his work.

To bring this high purpose down from the clouds, it may be profitable to illustrate the audit in depth with a few homely actual or theoretical examples. These are all cases involving the general accounting activity, but since the audit in depth knows no confinement, you will note that the path of reasoning frequently leads outside the general accounting office into the factory and the warehouse.

One phase of the general accounting audit must be the review of billing to customers and others. A cursory audit might consist merely of checking the totals of a sequential block of bills into the journal entry and ledger and testing the pricing and arithmetical accuracy of selected bills. The audit in depth starts with the same mechanical checks but goes on to seek proof (1) that all material shipped from factory or warehouse has been billed, (2) that pricing and contract terms are in accordance with marketing policy and (3) that billing has been recorded in the proper accounting period. For instance, sales contract terms may vary as to f.o.b. point, installation responsibility, acceptance or other factors affecting passage of title. In ordinary years a mistake or two in the timing of billing might be relatively unimportant. However, in years when there is a change in a company's effective rate of income taxes, it is vital that billing and the profit or loss thereon be recorded in the proper fiscal year. Accrual of liabilities in the period during which the obligation becomes established is equally important. A change in effective tax rates is a signal for the alert auditor to forget his standard audit program and concentrate his attention on the timing of operating transactions. Substantial tax losses may be averted by correction of timing errors.

Another illustration of audit contribution by going behind the billing to customers involves the sale of scrap. The superficial program would require the auditor to determine that the prices obtained for scrap were based on going prices quoted in trade journals or on competitive bids and possibly that weight of scrap billed was in agreement with shipping records. The audit in depth insists on corroboration not only of price and weight but also of the description of scrap shipped. It requires a determination that scrap has been properly accumulated and segregated, that it has been weighed before delivery to the scrap dealer and that physical safeguards against unauthorized shipment or theft are adequate. The audit cannot be made at a desk. The auditor must see for himself what scrap is generated in the factory and follow through to assure himself that his company is recovering the maximum possible amount of dollars for its scrap.

An auditor was able to contribute to a saving of more than $30,000 a year by suggesting that a scrap chemical material be carefully segregated and sold at the higher prices prevailing for unmixed scrap. Another auditor in pursuing the trail from scrap generation to sale discovered that many good screw machine parts were finding their way into the scrap containers. A simple fixture was devised to prevent this loss, which was running into appreciable annual figures.

Even the simplest phases of an audit may bear fruit. An auditor pursuing the routine task of verifying an office payroll noted substantial overtime payments to several well-paid service employees. The payments were properly supported by time cards and authorizations, but to satisfy his desire for proof the auditor stayed late one evening to observe these employees at work. They were present and working, not at their regular jobs but at such uncomplicated tasks as sweeping floors, emptying waste baskets and carrying on general janitorial duties. Not only were relatively high-rated people being used on low-rated work but they were also being paid at time and one-half. Part-time janitors were engaged, overtime was eliminated and the cost of this work was substantially reduced.

In another prosaic case the auditor decided to dig beneath the surface on an appropriation for major roof repairs on a rented building. The expenditure was obviously necessary and the required approvals had been obtained to proceed with the work. The auditor thought this might be a good time to educate himself in the fine print of the lease while making his routine check of rental payments. Careful scrutiny confirmed that the tenant was responsible for repairs—but only for repairs due to occupancy. The roof was repaired but as a result of the auditor's initiative, the lessor footed the bill.

Do these things seem obvious? Certainly they are obvious. When viewed "out of context," they may seem so simple as to be incredible. The general reaction is that such situations couldn't happen in a well-regulated business. The capable internal auditor, though an incorrigible sceptic, must believe in fairy tales, because these things *do* happen and are not necessarily unusual. The busier an office becomes, the more preoccupied its supervisors and employees are likely to become with the daily job of meeting ever-present deadlines and trying to keep the endless flood of self-regenerating papers from engulfing them. The auditor cannot and must not be preoccupied. He must be free to explore the most unlikely possibilities of error, waste or fraud. His task is not only to check *what* others have done but to find out *why* it was done and whether it was done wisely.

AUDIT PROGRAMS

In approaching the discussion of audit programming, it is important to distinguish between the general program set forth *for* the auditor and the specific program devised *by* the auditor for the particular assignment. A good general program is essential to a comprehensive audit, but it must remain general and suggestive if it is not to stifle the exercise of initiative. If the general audit program spells out required procedures in great detail, the auditor may well perform a technically competent examination, but when he has finished he may know nothing of the business he has audited, the reasons behind his audit procedures or the potential contributions he could have made by figuring out his own detailed program.

It is not within the scope of this discussion to set forth either a general or a specific program applicable to the general accounting activities. In the first place, these would fill a good-sized book; in the second place, they *have* filled many useful books; and in the third place, if I had any detailed procedural gems it would probably be inappropriate to broadcast them.

This leads to another thought concerning the confidential nature of programs, whether general or specific. It seems only reasonable that we not educate potential defaulters as to the mechanism of the booby traps we try to lay for them. We can talk with reasonable safety of objectives, principles and approaches, but we must play our cards close to the chest against the chiseler. The observant crook can guess most of the auditor's program without any help, but it often takes only one unexpected step to trip him up.

This brings to mind a cashier who had learned his lessons particularly well. He had observed and mentally catalogued every move the auditors had made each year. He knew that the lapping operation which he was undertaking would be detected by a comparison of cash receipt records with receipted duplicate deposit slips, so he substituted faked deposit slips for the real ones. He did not and could not know that the auditor's program called for one additional procedure which couldn't be observed in the office—the time-honored corrobation of duplicate deposit slips by checking them against the originals in the files of the bank.

Another defaulter, who was responsible for credit and collection work, walked into a similar trap after taking elaborate precautions to nullify standard controls and the regular audit procedures which he had observed. His method of operation consisted of (1) withholding collections from customers who had left the area or for other reasons were not expected to do further credit business with his company, and (2) writing off the amounts withheld as uncollectible. To support the bad debt write-offs and to satisfy the auditor, who he knew examined the credit files on all write-offs, he

manufactured voluminous correspondence with the customers involved, had fake letterheads printed and typed the customers' replies—all of them naturally explaining their inability to pay. These sad tales of hardship and bankruptcy would have satisfied the most critical auditor that this collection man had a heart of stone and a fist of iron; that he had literally squeezed the last penny from his poverty-stricken debtors. This was foolproof—except for one minor audit procedure which had escaped the culprit's watchful eye. The auditor regularly mailed letters of confirmation to customers whose accounts had been written off during the year, in addition to those whose balances remained open on the books.

Most frauds, except the clumsy spur-of-the-moment variety, are perpetrated with the full realization that they must run the audit gauntlet and accordingly any defaulter possessed of reasonable intelligence is going to anticipate and try to circumvent every audit technique of which he is aware. It is essential that he be kept in the dark as to the detailed procedure to be followed and, to accomplish this, the auditor should not disclose his program to anyone outside the immediate audit staff.

REPORTING

Let us turn now to the principles of criticism and reporting. The internal auditor will do well to look to the public accounting profession for proper standards of independence and integrity of opinion and criticism. His code of ethics must be self-imposed, since he is not under the same legal and formal professional compulsion as the public accountant. However, he cannot accomplish his purpose without such standards. This is more than a matter of ethics and business morality (which are certainly essential characteristics for every businessman regardless of position). It is the essence of the auditor's practical value to his company. He must form objective opinions, be willing to criticize where criticism is due, and report his findings and opinions accurately, completely and objectively. His work is valueless or worse if he permits friendship, likes or dislikes, loyalty or fear to influence the accuracy and completeness of his reports.

It is apparent that the auditor must be so placed in the organization structure that he is independent of the direction or influence of those directly or indirectly responsible for the work which he must audit. We could certainly not expect an auditor to report objectively to higher management on the performance of the individual who sets his salary rate. Even the conscientious and high-minded auditor cannot be expected to bite the hand that feeds him. His independence can be preserved only by placing his position properly in the organization.

While we are on the subject of reporting, it may be desirable to consider the purposes of audit reporting and the channels through which audit find-

ings can be most effectively communicated to accomplish these purposes. There are two reasons for audit reports: first, to correct unsatisfactory conditions and secondly, to inform higher level management and aid them in appraisal of performance of the work under their indirect control. These two objectives require different types of reports. The "direct action" report should be written in sufficient detail to aid in correction of the fault disclosed; it should be directed to the attention of the lowest level of management which has the power to accomplish the correction; and it should be written and delivered promptly—preferably while the audit is still in progress. This type of report is frequently informal and in the form of a letter or memorandum. The report for higher management, on the other hand, can be more formal and should summarize as concisely as possible only the more important findings and the corrective action taken or agreed upon. A voluminous compilation of nickel and dime exceptions is less than worthless in the hands of higher level management. Volume and verbosity tend to obscure the important findings and cast in doubt the total value derived from the audit. The brief formal report should be issued promptly but not until the detailed audit memoranda have been delivered to those who must take action.

It is difficult to suggest a rule specifying how high in the organization the audit report should go, since the individual preferences of the managers themselves must be given considerable weight. There is certainly no point in sending reports to people who do not wish to read them. As a rule of thumb, it would seem that the level of audit reporting could well be tied to the level of appraisal and measurement. For instance, if the operations of a department are subject to appraisal and measurement by an executive two organization levels above the manager of the department, the audit report should also be distributed two levels above the manager and to each lower echelon of management concerned.

We have considered at some length five principles of effective internal auditing. They might be restated in many ways but all would finally resolve into one simple precept. Effective auditing is the application of common sense to business problems. The successful auditor has always been and probably always will be the man who learns all he can about the business under audit, decides what needs to be demonstrated or proved and then proceeds to prove it.

ORGANIZATION AND FUNCTION OF INTERNAL AUDITING IN A MAJOR OIL PRODUCING COMPANY*

By MAX E. PRICE

Division Auditor, Pan American Petroleum Corp.

An interesting aspect of the oil production industry is the wide dispersal of its operations. This obviously has its impact on the system of internal control and the approach to internal auditing. The author provides a useful case-study of audit methods under these conditions.

INTRODUCTION

WE oil people, being naturally modest, like to say that petroleum is the cornerstone of our nation's abundant economy. Production today in the United States exceeds 7 million barrels daily, while refinery runs are over 8 million barrels. Petroleum and its products affect us directly and indirectly every moment of our lives. Literally, we couldn't eat without it.

BRIEF HISTORY OF STANOLIND

It may be interesting to you, and helpful in defining the subject of my paper, to review briefly the history of my company, Stanolind Oil and Gas Company. After all, the forms and extent of internal controls necessary in any business organization are determined largely by the character and activities of that organization. So it is with Stanolind.

The oil industry encompasses four basic functions—production (including exploration), transportation, manufacturing (or refining), and marketing. Stanolind is a producing company, concerned almost entirely with finding and developing new reservoirs of crude oil and natural gas. We have celebrated our 25th anniversary.

Stanolind is a wholly-owned subsidiary of the Standard Oil Company (Indiana), whose general offices are in Chicago. Following the dissolution of the Standard Oil Trust by Supreme Court decree in 1911, the Standard Oil Company (Indiana), or the Indiana Company as it is widely known,

*Delivered at a meeting of the Fort Worth Chapter, THE INSTITUTE OF INTERNAL AUDITORS, Forth Worth, Texas.

was exclusively a refiner and marketer of petroleum products. It depends entirely upon crude oil purchasing agreements to supply its refineries.

In the early 1920's, Indiana's management took a long look ahead and decided that the growing demand for petroleum would inevitably lead to intense competition for crude supplies. To protect its position, the company began an active program to develop its own crude production, through acquisition of producing companies and properties. Among the companies acquired were Dixie Oil Company, McMan Oil and Gas Company, and the Midwest Exploration Company, none of which was very large. In the interest of operating efficiency, these three companies were combined to form Stanolind, with headquarters in Tulsa.

The new company commenced operations on January 1, 1931, with 640 employees and about 15,000 barrels per day of production. In 1931 and 1932, various properties of the Southern Crude Oil Purchasing Company and the Midwest Refining Company were added. In 1935, Stanolind purchased the properties of the Yount-Lee Oil Company—at that time, one of the biggest deals in the industry's history.

These consolidations and acquisitions gave Stanolind producing wells and leases in nine states: Texas, Louisiana, Arkansas, Oklahoma, Kansas, New Mexico, Colorado, Wyoming, and Montana. Since then the Company has added production in Alabama, Mississippi, Utah, Nebraska, North Dakota, and Alberta Province, Canada.

At the end of 1955, Stanolind ranked fifth among U. S. producers of crude oil and natural gas liquids, with a daily average net production of nearly 252,000 barrels. We own over 11,000 wells, and operate over 13,000. We have an interest in 26 gasoline and recycling plants, and operate 15 of these. We hold non-producing leases and conduct exploration activities in 19 states, 3 Canadian provinces, and the islands of Cuba and Jamaica.

Our operations are carried on through 5 division offices, 27 district offices, 46 area and plant offices, and two subsidiary foreign exploration offices. We have over 8,500 employees.

Incidentally, most of our production comes from Texas. We are the largest producer of crude in West Texas, and rank second to the Humble Company in state-wide production.

MAX E. PRICE *is a graduate of Oklahoma State University with a B.S. degree in accounting. Following World War II he entered public accounting with Barrow, Wade, Guthrie and Co., joined Sears, Roebuck and Company as traveling auditor in 1946, joined Stanolind Oil & Gas Company now Pan American Petroleum Corporation in 1947. He was appointed Division Auditor of the Central Division in 1951 which position he holds today. Mr. Price is a Past President of the Oklahoma City Chapter of* THE INSTITUTE OF INTERNAL AUDITORS.

DECENTRALIZATION

No doubt you have heard or read about dispersion and decentralization of industry in the past decade. The two terms are not synonymous, although one may necessarily require the other for effective operations. Dispersion has to do with scattering the operation, which may be done for a number of reasons. When the operations are dispersed, a more effective operation can be had by decentralizing the authority to make necessary decisions. This may require the services of a number of staff operations such as accounting, tax, purchasing, treasury, traffic, industrial relations, and perhaps others.

Unlike most manufacturing industries, oil—our main product—is where we find it . . . whether it be in the uninhabited areas of the Rocky Mountains, the swamps of Louisiana or off the shores of Texas, miles out into the Gulf of Mexico. You can readily see that dispersion is automatically provided for the oil producer. His problem then becomes one of proper decentralization.

At the time of Stanolind's organization, in 1931, producing operations were directed from division offices in Tulsa and Fort Worth. With the addition of Midwest Refining properties, a Casper, Wyoming, division office was opened in 1932. When the Yount-Lee purchase was completed in 1935, a fourth division office was established at Houston. The Central division office was later moved from Tulsa to Oklahoma City.

By 1940, it became apparent that centralized administration of all the company's activities was becoming unwieldy. A decentralization program was developed, with the objective of making the division offices ultimately responsible for the direction of all phases of division operations. Implementation of the program commenced on January 1, 1948, with the designation of four division managers. By 1950, each division office had its division counterpart of every general office departmental function, except research, which is concentrated in Stanolind's Research Center at Tulsa.

In 1949, when we decided to enter Canada, a skeleton division office was established in Calgary, Alberta. Today this office too is completely staffed.

Our diversity of operations requires many services. From the accounting standpoint, over 8,500 employees must be paid twice monthly, some 25 to 30 thousand invoices for materials and services must be paid, and a similar number of material transfers must be recorded. From the revenue side, the sale of some 250,000 barrels of crude and liquids, and 930 million cubic feet of gas per day must be recorded. The many other services of accounting for company assets and providing periodic reports to management also require a tremendous amount of record keeping and verification.

THE AUDIT OBJECTIVE

A number of years prior to decentralizing control of operations, our company established policies, plans and written procedures. The full decentralization move required only minor revisions to written procedures. When a company delegates responsibility to individuals or subordinate units, the management function of control must be strengthened by bridging the gap between management and operations. To accomplish this feature, the company established an audit section at the headquarters city of each division with no restrictions on the review of company operations. In other words, there are no sacred cows.

ORGANIZATION OF INTERNAL AUDITING

Each audit group is under the supervision of a division auditor and the number of audit personnel is dependent upon operations of the particular division. The division auditor reports to the audit supervisor in the general office. He in turn reports to the manager of the administrative department. You will note we are independent of operating and staff functions of the division office.

THE AUDIT PROGRAM

Many internal audit programs are designed around specific areas of responsibility, such as accounting, purchasing, industrial relations, advertising, marketing and branch offices. The program under which we operate is not necessarily designated in this manner. Principally, we have four categories of audits as follows:

Division office audit
Field audit
Part interest audit
Special audit

DIVISION OFFICE AUDIT

The division is a complete operating unit encompassing almost all functions of the company and is normally under the direction of a vice president and division manager. The division manager has under his direction the two operating functions of exploration and producing as well as the staff functions of accounting, purchasing, treasury, industrial relations, legal, and procedure. In order to obtain adequate audit coverage of these functions at the division office, it was decided that the work would be performed on a feature basis such as cash disbursements, accounts receivable, material and equipment, appropriations, payrolls, employment, and so on. In the performance of an audit feature, we may cross the lines of responsibility of a number of separate departmental functions.

The internal audit in Stanolind is performed on a post audit test check basis and the program is designed to:

1. Verify correctness of accounting and statistical data developed within the division
2. Verify compliance with policies, plans and procedures
3. Determine that company assets are protected from losses of all kinds
4. Review and appraise the internal records, controls, and procedures of the company in terms of effectiveness and adequacy.
5. Appraise operating performance under policies, plans and procedures and make recommendations for improvement.

To further illustrate the point, I should like to briefly discuss the audit feature covering material and equipment (excluding appropriations and incomplete wells). The audit objective for this feature set out in the manual is "To verify that the acquisition, recording and transfer or disposition of material and equipment is in accordance with policies, authority delegation, and procedures, appropriations prepared when required, and that expenditures are made in accordance with company standards and are properly accounted for."

The auditor must first determine what was bought so he must start with cash disbursements in the accounting department. When selecting the items for examination, the auditor determines compliance with disbursement procedure, receipt of material, discount, taxes, account distribution, approval for payment, necessity for appropriation, compliance with company material standards and so on. He then traces these items back to the purchasing department where the transaction is reviewed to determine that it is supported by a properly approved requisition, whether the material was available from surplus, bids secured when required, and compliance with established procedures. Briefly this covers material acquisition. Material movement and disposition is reported on material transfer forms. These forms are examined to determine compliance with company procedure with respect to preparation, accounting treatment, pricing, condition of material, proper authority, compliance with joint operating agreements and a number of other items.

This does not necessarily cover each step of the audit procedure but will serve to show the completed transaction approach used. By tracing transactions from origination to completion, the auditor has viewed the transaction from the standpoint of all five functions of the audit program set out above.

FIELD AUDIT

The operating functions of the division are carried on by district, plant, and area locations as well as a highly roaming group of people known as seismograph parties. These locations may be comparable to branch offices. To these areas of operations, certain responsibilities and duties have been delegated or assigned. This is the area where a major portion of our source media is created. The audit of these areas is performed more as a responsibility type of audit.

The field auditing program was developed to establish, through a review of source data and by actual observations of operations at these areas, that operations are performed in an economical manner, based on proper authorization and approvals, in compliance with company policies, authority delegations and procedures, and that the operations are accurately reported. This audit is very important because incorrect underlying documents do not beget correct accounting and statistical data. The features of this type of audit most generally have two aspects of verification. The office verification which consists of a general review of all source data, underlying transactions, etc., submitted to the division office and a field verification wherein information obtained through observation of operations is appraised and correlated with related reports.

We have written audit manuals covering the division office and field audit programs. These manuals serve as audit guides and cover only the minimum number of checks necessary to accomplish the audit objective. The auditor must be constantly on the alert to recognize situations which require enlarging the audit scope.

PART INTEREST AUDIT

Joint ownership of producing properties and auxiliary facilities in the oil industry may come about in a number of ways, whether it be for economy of operations, conservation of resources or protection of the correlative rights of owners. These actions may be voluntary on behalf of the owners or forced by governmental authority.

When joint operations are entered into, the parties concerned execute an operating agreement or contract designating one party as operator and setting forth what can be charged as well as the basis for making the charge to the joint account. In order to protect our interest in the operation, it is necessary to audit the books of the operator. The audit of this type of operation has two specific functions: first, to determine whether the joint property received the material or benefit of services charged and, secondly, whether the material or services are allowed by the contract and are charged in accordance therein.

SPECIAL AUDIT

Audits performed under this category generally result from a contractual relation with outside parties. Principally these audits cover gas sales contracts and processing agreements, construction contracts, license agreements, and other contractual relations.

EXCEPTIONS AND RECOMMENDATIONS

Briefly the audit exceptions fall into two categories. Those which are isolated incidents but are of major consequence or amount and those which constitute a condition. We do, however, obtain correction of numerous minor clerical errors which are not reported.

In the performance of a feature, the auditor has an opportunity to critically review policies, plans and procedures in action. This will naturally provide an excellent basis to make recommendations for improvement.

THE AUDIT REPORT

Basically we have three types of audit reports; monthly, at the end of an engagement, and a six-month summary.

The monthly report is a progress report to the audit supervisor covering auditing activities and comments.

The report on field audit, part interest and special audits is prepared and submitted at the conclusion of each assignment. The field audit report is addressed to the audit supervisor with copies to the division manager and applicable vice president in the general office.

Part interest and special audit reports are addressed to the person requesting the audit with copies to the audit supervisor and division manager.

The six-month report is a summary of all major exceptions and comments for the semi-annual period. Copies of this report are furnished to the division manager and the audit supervisor in the general office. The audit supervisor consolidates the six-month report for all divisions and the general office for presentation to the directors of the company.

MANAGEMENT CONTROL--SOME AUDIT IMPLICATIONS*

By WILLIAM TRAVERS JEROME III
Associate Professor, Syracuse University

Internal control is designed to produce efficiency; executive control is designed to produce profits. The two types of control, while different, are compatible. The author urges the internal auditor to penetrate into the area of executive control and thus increase his usefulness to top management.

THE purpose of this paper is to discuss the nature of management or executive controls. In particular, it is intended to indicate some of the reasons why an internal auditor might find it rewarding to know more about the composition of his own company's system of management control. An understanding of the principles underlying such a system is very nearly as worthwhile for the auditor as his knowledge of internal control principles.

Control, of course, is a most illusive concept to define. Therefore, to avoid some of the semantics involved in this word, I propose to approach the subject of management control from the standpoint of internal control.

Such an approach has merit in that the concept of internal control is familiar to both auditors and the financially trained. In fact, most approaches to management control have been little more than an expansion of this internal control concept. Such, for example, seems to be the approach used by Mr. J. H. Hennessy in a suggestive article on "Management Controls," appearing in the September 1956 issue of THE INTERNAL AUDITOR.

INTERNAL CONTROL—A LIMITED CONCEPT

The now classic statement describing the internal control concept can be found in the special report of the American Institute of Accountants' Committee on Auditing Procedure, published in 1948. This statement, although familiar to all auditors, deserves partial repetition here:

> "Internal control comprises the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed

* Delivered at a meeting of the Niagara Frontier Chapter, INSTITUTE OF INTERNAL AUDITORS, Buffalo, N. Y.

managerial policies. This definition possibly is broader than the meaning sometimes attributed to the term. It recognizes that a 'system' of internal control extends beyond those matters which relate directly to the functions of the accounting and financial departments."

The principal difficulty with this statement is the notion that internal control enhances "operational efficiency." This sounds like whistling in the dark. Most attributes of internal control necessarily tend to be both static and restrictive. This restrictiveness results from the fact that a system of internal control is primarily a closed system. In this respect it differs materially from the open-endedness that should characterize a system of executive controls.

For that matter, internal control is a concept clearly intended to break down a whole multitude of operations in terms of accountability—accountability primarily in the sense of the preservation of assets and the accurate flow of accounting information. Internal control is thus principally an organizational concept based upon a system of built-in checks and balances, especially designed to separate the jobs of record-keeping from counterpart operational or custodial responsibilities.

The assumption underlying most systems of internal control seems to be essentially this: If prescribed procedures are followed within a highly segmentized organization, then this system of checks and balances will insure efficient operations. Ironically, however, the attainment of efficiency does not guarantee profitability.

The concept of internal control, therefore, is only one part of the control story. Internal control should never be confused with a system of management or executive controls. To be sure, a system of internal control will provide control at lower echelons of management. Let's make no mistake about this. Similar control principles, however, are simply of limited applicability at top management levels.

The reason for this limited applicability is really quite obvious when pointed out. *Any system of internal controls is the creation of top management.* Top management has established the system expressly to make certain that lower management carries out its commission. Consequently, the success of the system superficially can be judged relatively easily. All that need be done is to compare actual results with planned results, or, in some cases, to determine the degree of compliance with established procedures. In other words, *success and compliance tend to be one and the same thing under most systems of internal control.* Such has to be the case because top management has said in effect to lower management: You follow instructions and business will prosper.

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A SYSTEM OF EXECUTIVE CONTROLS

But this sort of approach begs a very critical question: How does top management know the most profitable plans to follow? Or, to go one step further, How does top management know the best ways to implement such plans? Is not the need to answer these questions a major reason for executive controls?

At top management levels, in other words, unlike at lower management levels, there is no structure of control imposed by higher authority within which the executive can operate. Such controls as exist at this level must be self-imposed. But compliance with such controls cannot be regarded as a measure of success. The only objective measure of success at this level is profits. This is the sole justification of any top management control—its contribution to over-all company profits.

To be sure, other measures must be available to judge the success of a company's system of controls. These tests might be share of the market, progress in product design, increases in productivity, or success with executive development. Such measures, none the less, are still basically subjective. Profits are the only objective measure of management's success.

What, then, would constitute a system of executive controls? In my opinion, there are four characteristics of any effective system of executive controls.

Organization: As pointed out above, a system of internal controls is largely restrictive in concept. This is particularly true in regard to the plan of organization where jobs are specifically delimited and an aura of sanctity pervades organizational lines.

At the executive level, however, emphasis is often more upon finding ways of bridging organizational lines, of developing teamwork and of identifying a community of interests. Organization at this level accordingly is primarily a matter of establishing objectives and getting the right men in the right jobs with the proper authority to work together to achieve these objectives.

The company with good people comprising its organization, of course, greatly simplifies its control problem. This is so because in the final analysis

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WILLIAM TRAVERS JEROME, III, *Associate Professor, Syracuse University, joined the Faculty of the Syracuse University College of Business Administration in 1953 as Director of the Army Comptrollership Program and also of the Syracuse Executive Controls Program. After graduation from Colgate University, he attended Yale Law School and Harvard Business School.*

Dr. Jerome has served as Assistant to the President of Middlebury College and as Research Associate at the Harvard Business School.

all controls are of people and by people. At the same time, at higher management levels, no matter how good the organization, there is still the need for control.

However, control at the executive level is largely a matter of balancing the conflict of interests between those in production or sales, research or personnel. This is different from the emphasis required in organizing for internal control where the stress is upon preservation of assets and the reliability of accounting data.

In other words, organization in the sense that it is a basic characteristic of a system of executive controls is not an outgrowth of human frailty, although this frequently may be its genesis in systems of internal control. Rather, the design of a company's organization should be such as to give recognition to the fact that any imaginative group of executives will have many diverse interests. The skill with which these interests are reconciled may largely depend upon the skill with which the wisdom and profitability of alternative actions can be measured. Profits thus become of paramount importance in synchronizing executive action because they do represent a transcending interest.

A Continuing, Coordinated Approach to Planning, Budgeting and Follow-up: Control at higher management levels becomes largely a matter of self-control in terms of self-determined goals or objectives. These objectives become translated into plans and programs which later may take the form of budgets. This planning process is not something that ordinarily can be left exclusively to the president or controller or some separate planning body. Nor can the follow-up be left solely to, say, the internal audit department. To be effective, planning must be the product of the thinking of those who ultimately will put the plans into operation.

To the extent that this planning, budgeting, and follow-up is a continuing, coordinated process, a company's system of controls will tend to be alive and open-ended. To some degree, the auditing of results will be the responsibility of all management levels. A major contribution of internal auditing accordingly will lie both in seeing that the follow-up is systematically performed and in helping to focus attention on areas that may require strengthening.

Information: Communication in the sense of transmitting orders or reporting accomplishment or requesting assistance is at the heart of any system of executive controls. Much of this communication or information is in the form of figure data. Information that comes up or across the line serves as a basis for informed decisions by higher levels of management. Information that goes down or across the line is a way of getting lower management levels to know about policies and procedures.

In no area of executive control is the internal audit activity of more substantial value to management. An effective internal audit department can do much to keep the avenues of communication both open and responsive to the needs and wishes of all members of an organization. Accuracy of data need be continually verified. Even more important, the significance and materiality of the information generated or omitted should be continually evaluated. Clearly, the bigger and more decentralized the business, the greater is the significance of information and its skillful interpretation and dissemination.

Product Development: In addition to the three aspects of executive control considered above, product planning and development should at least be mentioned. The tendency on the part of auditors, of course, will be to minimize this particular aspect of executive controls on the grounds that it is of little concern to them. And yet in most respects product development is the master control. All the other controls are meaningful only in terms of a company's services or products. Organization is frequently based upon product lines; planning starts with a forecast of the public's demand; and most of the vital statistics collected have to do with the product's life cycle.

Since these are all things that are of concern to many auditors, an interest in product planning and development is not as unreasonable as it sounds. The value analysis program, for example, promoted by a company such as General Electric is not unlike the work done on occasion by auditors. Here, in effect, a product is "exploded" and its various components analyzed on the basis of alternative materials, suppliers, design, and the like. Or, again, auditors may get into practices concerning price concessions or customer service. All of these problems bear upon the broader subject of product planning and development.

ESSENTIAL SIMPLICITY OF MOST ADMINISTRATIVE CONTROLS

Is the system of executive controls described above too broad to be useful for those of you who are auditors? I don't believe so. Certainly, my intent has been to describe a system that is essentially open-ended and readily adaptable to all organizations.

Actually, controls—particularly management controls—may be very simple things. A report may become a most important sort of control if management becomes interested in it. A ratio like sales to inventory or profits to investment, may become all-important. Confidence on the part of employees in the fairness of the grievance procedures may be an influential factor in controlling output. Some of the most far-reaching controls may thus consist of the simplest sort of things.

A great deal of harm has been done, I believe, in thinking of controls in terms of techniques rather than in terms of peoples' attitudes and behavior. Push-button control has an appeal that is difficult to escape. There is a real tendency, particularly on the part of auditors, to want to over-define responsibility and to over-systematize. Of course, this helps to simplify the audit job, but controls tend to breed controls along with bureaucracy's dry rot.

Thus, Hennessy's article on "Management Controls," to which I earlier referred, disturbs me. It disturbs me in spite of his very keen awareness of the human factor because he seems to regard this factor as something to be controlled from above. "Now with policies which provide the basic objectives," he writes, "and the rules of conduct to be observed in achieving these objectives, and with an organization structure to show people where they fit into the company complex of manpower and facilities and with instructions to tell them the what, where, when and how of the things they are to do, *we are almost in a position to commence our control over these people.*" (Italics mine.)

Certainly from my standpoint a very dynamic aspect of executive controls is lost as soon as such controls are regarded *as primarily an aid to those who direct action.* Is not an equally important aspect of any system of control that of making easier the job of those who must do the acting?

A BROAD CONTROL CONCEPT — SOME FURTHER IMPLICATIONS FOR AUDITING

The contrast drawn between a system of executive controls and a system of internal control deserves additional elaboration. Certainly, the implications for internal auditing call for far greater attention than it is possible to give here.

First of all, nothing has been said to alter the fact that the auditor's principal responsibility, now as always, is to see that the internal control system is working effectively. The test for effectiveness, however, goes beyond the notion of preservation of assets and compliance with procedures. An additional test should be whether any given internal control is contributing to the job of maximizing profits. Also, various aspects of the system of internal controls should be evaluated in terms of their influence on the effectiveness of the existing system of executive controls.

Typical examples of a lack of coordination between the system of executive control and internal control are the following: reports that have outlived their usefulness; compliance with budgets or procedures when changed circumstances fairly cry out for modifications; or elaborate checks to safeguard items of little value.

Second, control from the viewpoint of internal auditing is fundamentally a matter of evaluation. Evaluation in turn depends upon a clear understanding of the relevant company norms or goals or standards that alone can give meaning to actions taken. There simply is no such thing as control without objectives. To audit results intelligently, in other words, is impossible without some knowledge of company objectives and the reasoning underlying the setting of the standards required to obtain such objectives. Accordingly, the top-grade auditor should insist on the desirability of his reviewing the way such measures as standard costs or engineering specifications or budgets are set. This is one way whereby a system of internal controls can be made more responsive to the needs of management at both operating and home office levels.

And third, periodic reminders of the danger of over-systematization are not without merit. We have already pointed out that internal control tends to be based upon a formal system of procedures and measurements. Implicit in all these measurements seems to be the assumption that the secret of efficiency (sic, controls) is standardization and repetition.

An important thing to remember, however, as already pointed out, is that efficient operation is not always profitable operation. You can have excellent credit controls, for example, but have these cost you thousands of dollars of potential profits as a result of turning down relatively many accounts to reduce the chances of a few bad debts? Or you can have excellent quality and scrap controls yet actually be losing money because the useful life of the finished product will be considerably less than the life span of its components.

What I am suggesting is that the cardinal objective of control is to release the energy and initiative of people, not to curb them. Repetition or standardization is valuable only to the extent that it simplifies the work of individuals so that the resources of a business may be used to best advantage.

PLANNING AND CONTROL FOR PROFIT

The emphasis in this paper on evaluating controls in terms of their combined effect upon profits seems in keeping with the renewed interest in return on investment as a major control device. This device seems illustrative of top management's desire to get away from too much home office control. The emphasis is rather upon finding ways to release the talents of management at lower levels. The danger here, of course, is that profits or return on investment be over-emphasized as a control. Too great concern with return, especially in the short run, could conceivably lead to certain attitudes and behavior incompatible with over-all business success. Thus, in the interest of

short-run profits, share of the market or research or executive development might be jeopardized.

All of this again brings us back to the one inescapable fact that any single control, or system of controls, must be evaluated in terms of their effect upon peoples' actions. In the final analysis, control is meaningful only in terms of the attitudes and behavior of people. The effectiveness of any system of controls, therefore, must be judged in terms of the success achieved in having people work together towards common ends calculated to maximize long-run profits.

Controls of material, for example, are only controls of the people who are purchasing that material, storing it, processing it, disposing of it. Thus, attempts to control quality or flow of work or anything else depend upon the success you have in influencing the actions of people.

When people understand the goals, the objectives, or the norms—which in effect become the standards of measurement making control possible, they are generally inclined to act more willingly. Such an approach to control becomes a way of motivating action rather than impelling it.

SUMMARY

The area of control is necessarily broad. This is so because an understanding of control is dependent upon an understanding of the art of management. On the other hand, the message of this paper has been basically simple. It has cautioned against too great audit infatuation with the mechanics of internal control.

An over-emphasis upon the principles that make internal control effective can only be at the expense of the principles underlying a successful system of executive controls. The incompatibility existing between the two systems should not arise, however, because of any irreconcilable differences between the two. The incompatibility can only come from a failure to identify clearly the differing needs of top management and the men on the firing line.

Thus, much of *the basic difficulty in developing a workable system of control lies in a failure to understand the several different forms it can take.* If, for example, control is regarded primarily as a matter of directing activity from above, then compliance with orders by lower management levels is a fair measure of the effectiveness of such controls. The audit activity under these circumstances might quite properly be limited to a checking of such compliance.

On the other hand, if control is regarded primarily as a matter of setting guide lines to achieve jointly agreed-upon ends, then both the ends and the

means to those ends should be continually re-appraised and re-evaluated. The audit activity accordingly might quite properly get into the planning phases of operations. For, under these circumstances, the goals or objectives themselves become the means or controls for appraising past results and future action.

Certainly, some such concept of control as this last offers a possible answer to the challenge in Alexander Lindsay's statement that:

> "Industrialism has introduced a new division into society, the division between those who manage and take responsibility, and those who are managed and have responsibility taken from them. This is a division more important than the division between rich and poor."

By virtue of their travels throughout an organization, internal auditors have a magnificent opportunity to be purveyors of a positive concept of management control. Certainly, this is one reason why auditors should be interested in helping to develop a consistent approach to control in their own particular company.

THE ROUND TABLE

Edited by DONALD T. BARBER

An important advantage of membership in our INSTITUTE is the opportunity for sharing internal auditing experiences with internal auditors in other companies. One way of doing this is by contributing to and reading the Round Table. This feature is for the exchange of the day to day experiences in internal auditing that have resulted in savings or efficiencies, or for the telling about some special auditing service to management. In every auditor's background of experience there are many items that should be shared in this way.

All manuscripts will be acknowledged but the names of contributors will be published only with permission. Please address:

The Round Table
The Institute of Internal Auditors
120 Wall Street
New York 5, N. Y.

* * * *

THE GOLDEN RULE OF INTERNAL AUDITING

There are two ways in which internal auditors can carry out their audit assignments; two different attitudes that may be adopted. First the auditor can try to "find something that the other fellow had done wrong," or secondly, he can "prove the other fellow right."

If he tries "to prove the other fellow right" he will create better relations with the other members of the organization. He will obtain their trust and confidence. The finding of something wrong too easily causes a reaction from fellow employees of suspicion and mistrust. This is surely not a condition that is conducive of full cooperation with the internal auditor and must often result in ineffective audit results.

Also of importance is the likelihood of an additional self-check of the internal auditor's work. An attitude of "finding something wrong" too easily

may lead to inconclusive audit evidence and a recommendation that may be unjustifiable. The auditor with the attitude of "proving the other fellow right" will add a sufficient number of extra audit steps to prove conclusively that the person or persons involved are right or wrong. If the additional audit steps proves them to be right a result will be produced opposite to the earlier premature assumption. The auditor's work will be more thorough, his investigation more complete and the facts discovered will give full support to his recommendations.

The only rule for internal auditing is the Golden Rule; it is the "proving of the other fellow right." At least we should try to do so because sometimes we may be the other fellow.

Albert E. Marien
University of Illinois
Urbana, Illinois

* * * *

RECOVERY OF ROYALTY

Our company had leased several acres of our undeveloped properties to a quarrying and road building company. Provisions of the lease provided for a minimum annual royalty payment on the sale of all grades of road building stone. Some three years after the acceptance of this agreement and shortly after the establishment of an Internal Audit Department, operating in the official capacity thereof, it was decided to visit the quarrying company to verify the royalty payments as reported to us by them, in accordance with permission granted in the lease agreement.

In the performance of the audit the operations of the quarry were reviewed to determine the extent of their controls, assuring that each truck loaded and shipped was properly weighed prior to leaving the quarry and that all trucks so loaded would be recorded. We further verified the shipments by comparing the Scale House copies of the Scale Tickets with the Sales Journal maintained by the accounting department and traced the entries in the Sales Journal to the General Books. In the course of this examination of the Scale Tickets and while accounting for the numerical sequence thereof, it was noted that a large number of these tickets covered truck loads of sub-base material, which tonnage was eliminated when preparing their royalty report for our company.

As the original agreement provided for the exclusive sale of first grade material, these shipments of sub-base materials were brought to the attention of our management and further negotiations were entered into with the

quarrying company with the result that the original agreement was amended to provide for the sale of this sub-base material at a royalty commensurate with the value of the material. The net savings to our company amounted to approximately $20,000 in recovery of previous years royalties and an estimated $7,000 additional royalty annually, due us on the sub-base material, which payments would have been lost to the company except for the disclosure developed by the Internal Audit Department.

* * * *

INVENTORY CONTROL OF SERVICE PARTS IN BRANCHES

In our company service parts are stocked in each of approximately five hundred branch office locations. In the internal auditor's review of the year and physical inventories there appeared to be an excess quantity of unusable and obsolete parts. The internal audit studies were continued and as a result it was established that

(a) Stocks of parts for discontinued models were excessive in terms of their usage.

(b) A high percentage of the unusable parts were for discontinued models.

Resulting from the discussions based on these findings the following changes were made,

(a) Parts for discontinued models were eliminated from the inventory accounts and all subsequent shipments and sales were accounted for directly through the profit and loss account.

(b) Branches were instructed to reduce their stocks of parts for discontinued models and to place future orders on a specific usage basis only.

Since these changes were put into effect the stocks of parts for discontinued models is more realistic in terms of usage and there has been a decline in the quantities of unusable parts.

* * * *

THE FUNCTIONAL AUDIT OF A SALES OFFICE

One of the first assignments of our internal audit department was the functional audit of a by-product sales and billing department. This de-

partment of our business was established a few years ago to sell certain by-products in demand outside the company and were being produced in excess of our company's requirements.

The principle product of the company is obtained by refining raw materials. In this process certain fluxes and additives are required and since they account for practically all of the material costs of refining the raw material a plant was established for their production. But in the production of these items certain by-products were derived which were greater than the company's requirements. It was for the sale of these by-products that the sales division, being audited, was established.

During the course of the audit it was discovered that in recent years the external demand for these by-products had tapered off so that virtually no outlet existed for them. This was due to the development of substitutes more acceptable to the public. However, although the demand had fallen off there was no corresponding reduction in the sales force employed for their disposal.

When this fact was reported to our management we were asked to expand the scope of our audit. First to determine what disposition could be made of the excess personnel employed, and secondly, to develop a plan for the distribution of the work load so adequate controls could be maintained with a reduced work force.

This was accomplished with a resultant estimated saving to the company of $15,000 annually through the reduction of the work load, substitution of less expensive forms, and the absorption of the excess personnel into the company's other operations. These people were made available to other departments of the business where difficulty was being experienced in obtaining trained personnel in the labor market of today.

* * * *

FIRE PROTECTION

Fire losses are a major loss item in industry in North America every year. It is obviously an important subject and one that may prove very profitable for study by the internal auditor.

There are many industries having modern buildings that are fully protected by sprinkler systems. There are, however, many locations and warehouses having no such protection where a sprinkler system could be installed and paid for from savings in insurance premiums.

In most cities there is a service that electronically connects the sprinkler system to a central alarm board that is maintained by a separate agency. When a sprinkler head is activated in a building a signal is automatically flashed on the agency's board and the nearest fire station is notified. Within minutes of an alarm a car is dispatched from the agency and the company's personnel notified if the plant is unattended. Whenever the water pressure is not maintained above a safety minimum in the sprinkler system a warning is flashed on the central control board.

Two years ago in my company the installation of a sprinkler system connected to a protection agency together with the addition of a few fire doors has resulted in reduced insurance premiums. The reduced premiums will pay for the charges in two years. From then on the savings will accrue to the company. And, of course, there is the comforting thought on the part of employees that the plant will not be burnt out but will be operating as they report to work from day to day.

A. R. Hendricks
Gordon A. MacEachran Ltd.
Toronto, Ontario, Canada

STUDENT'S DEPARTMENT

Articles in these pages are compiled because of their special help and interest to students.

Edited by STANLEY J. BLAZNEK

PRIVILEGES

IT is a privilege to live in a country such as ours with its abundance of opportunities in various fields of endeavor.

It is a privilege for a student to be able to complete a college curriculum with a major in accounting which will supply him with the necessary theoretical background to apply himself in the business world.

It is a privilege, indeed, for him to become associated with a progressive company as a member of its established internal audit staff. The advantages are many; and foremost, is the satisfaction of being able to assist management in achieving the most efficient administration of the operations of the organization.

Duties and responsibilities of the internal auditor are basically accounting and auditing and, of necessity, include direct contact with all levels of line and staff personnel, which consequently offers him many convenient occasions to appraise the organization and obtain a first-hand working knowledge of all phases of operation much more readily than would otherwise be possible to acquire through experience in a line responsibility position.

Furthermore, direct on-the-job contact with management personnel provides the individual with an opportunity of having his services and ability recognized, thereby providing him with unlimited promotion possibilities.

THE NEED FOR COLLEGE COURSES IN INTERNAL AUDITING *

By EARLE H. CUNNINGHAM
Steel Door Corporation

The ever-increasing demands by management upon internal audit staffs are being accepted and accomplished, with a degree of hardship due to lack of qualified university graduates. While basic accounting training is as good as or better than ever, there is an apparent need for courses in the development of responsibilities in the field of constructive service to management.

THE need for college courses in internal auditing is a much debated subject. While college educators hesitate to add special courses to an already crowded curriculum, those interested in the field of internal auditing see the need for a higher grade of training for the internal auditor than is currently available. This need stems, primarily, from the broader responsibilities assigned to the internal auditor, and the increasing range of services he is required to render.

The early type of internal auditing was largely a clerical activity maintained for the purpose of detecting and preventing clerical errors and fraud; and the internal auditor rarely operated outside of the field of general accounting. While some of the larger companies developed their internal auditing to a fairly high standard during this early era, there was little uniformity in the requirements of the internal auditor. This condition can be appreciated when it is realized that prior to 1940 there were no text or reference books on this particular business function, and no authoritative definition of internal auditing.

Each company making use of internal auditing created this function in accordance with its own concepts and particular needs. In those cases where all operations were established at one location, were controlled by one accounting system, and were subject to close management supervision, the clerical type of internal auditing generally prevailed. The internal auditor's duties consisted of such routines as checking mathematical computations, testing distributions, determining sufficiency of approvals, effecting reconciliations of accounts, substantiating balances, ascertaining the adherence

* Reprinted from The Accounting Review—Jan. 1955.

to policies and procedures, and similar matters. Under present concepts the employee performing such services would be termed as "audit clerk."

In contrast to the foregoing there were some companies such as railroads, packing companies, farm implement companies, and automobile companies, which had scattered operations. Factories, warehouses, or branch stores were established at points of economic value to the company and its customers. The remoteness of these operations presented many management problems. Daily observations and supervision by top management were not possible, and the performance of branch management had to be evaluated largely through the medium of reports. To assure that directives and procedures were being observed, that cash and property values were being conserved and properly accounted for, that company policies were being carried out, and that operating and other reports were factual and properly prepared, management found it necessary to create an impartial inspections agency for the purpose of making periodic examinations of branch operations: a staff of traveling auditors.

The traveling auditor provided management with a practical and effective means of contact with field operations. The character of services rendered was largely responsible for elevating the "traveling auditor" to a much higher status than was enjoyed by the "audit clerk." Management had to depend upon the traveling auditor for much of the unbiased and independent reporting of branch operations. Contrary to current practice, some companies in this early era conferred upon their traveling auditor considerable management authority. In some cases he was authorized to hire and release personnel, change or modify routine procedures, and perform various other specific acts. Surveys and investigations were frequent assignments, and valuable information was passed to top management through the medium of the traveling auditor. Undoubtedly, it was management's experience with this type of internal auditing that contributed largely to its development. However, the development was on an individual company basis, since there was little exchange of business information among companies in these early days; and there was no available material defining the duties and responsibilities of the internal auditor.

EARLE H. CUNNINGHAM *became Vice-President of Steel Door Corporation after retiring from the position of General Auditor of General Motors Corporation. A graduate of Portland University with the degree of B.C.S. and M.C.S., he had several years of public accounting and university teaching experience before joining General Motors Corporation.*

Mr. Cunningham is a Charter Member of THE INSTITUTE OF INTERNAL AUDITORS *and a Past President. He was a member of the 1954 Task Committee on Internal Auditing Education of the American Accounting Association.*

With the publication of Brink's* book on internal auditing, and the organization of THE INSTITUTE OF INTERNAL AUDITORS in 1941, concepts began to crystallize and basic standards of practice were developed. These factors, along with the management problems which developed as a result of World War II, caused internal auditing practice to spiral to new heights, both in quality and quantity of practice.

While normal management problems have been constantly increasing over the years, World War II brought a pyramid of new problems. The social and economic problems that have developed in the past ten or fifteen years have been so vital to business that management has been forced to devote a large part of its time to their solution and administration. This condition has forced top executives to delegate many of the normal duties that they formerly performed. Today, the administrative problems of our larger companies are so numerous and complex that top management can do little more than to formulate policies and procedures, and review and interpret reports on operations. Even in our smaller companies, management is finding it necessary to delegate more and more of its responsibilities to subordinates for execution. The increase in management problems over the years has forced management executives farther and farther away from line operations and has curtailed the opportunity for personal observations and evaluation of operating activities. As a result, management has been forced to rely more and more upon its system of internal control to provide operating data and the assurance that its directives were being faithfully executed. The type and number of individual controls making up the over-all system of internal control will vary with the size and nature of the business and the requirements of management. Some of the more common controls are:

1. Supervision
2. General Accounting
3. Internal Check
4. Internal Auditing
5. Cost Accounting
6. Budgetary Control
7. Procedure Manuals
8. Statistical Reports

Each type of control has its own important part to play in the general scheme of management; and most of them interlock with the general pattern of operations to such an extent that they become an integral part thereof.

While "internal auditing" is one of the several controls maintained to serve management, it differs from most of the other types of control in that

* Internal Auditing, Victor Z. Brink, Ronald Press, New York, 1941.

it acts as an independent agency, and is charged with the responsibility for measuring and evaluating the adequacy and effectiveness of other controls.

The best system of internal control ever devised will not sustain its par of performance and effectiveness without proper maintenance. Policies, procedures, internal check, and other routines are subject to deterioration and obsolescence as much as physical properties. Though they may be entirely adequate at the time formulated, changing conditions are bound to have an obsoleting effect. It is the responsibility of internal auditing to keep other forms of control under close observation, and to make frequent tests of their adequacy and effectiveness.

Because of the internal auditor's responsibility in respect to the system of internal control, it is important that this subject be given considerable emphasis in any contemplated training program. The student should be well informed on the nature, objective and relationship of the various individual controls, and the internal auditor's responsibility in connection with each.

Much of the inspection work and checking performed by the early type of internal auditor was against established standards or predetermined objectives, and did not require the exercise of management judgment. The internal auditor was frequently referred to as a "checker." But today, the internal auditor is viewed as an appraiser. It is his duty to observe, review, inspect, appraise, and report his conclusions to management. His broad responsibility in this respect will cause him to deal with many problems, some of which may involve expensive and radical changes. His appraisals must be sound and amply supported by adequate working papers and supplementary data. In many cases there will be no established standards or predetermined objectives for him to use in formulating his conclusions. Such instances call for the exercise of judgment based on a thorough knowledge of the business. To be able to measure up to such issues, the internal auditor must be a constant student of his company's affairs. No other employee of the company has such an excellent opportunity to gain a comprehensive knowledge of the business, as does the internal auditor. His unlimited right of inspection provides him access to every phase of the company's operations. The degree of business knowledge that he acquires through this opportunity will be reflected in the quality of the appraisals that he will have to make.

While checking and verifications are still a part of the contemporary internal auditor's routine, training programs should point out that the emphasis is more on appraisals. The successful internal auditor must be constantly alert for matters that may need inspection and appraisal. As he travels about the company he must critically view all matters coming within the range of his responsibility to determine their need for close inspection and appraisal. Some of his inspections and appraisal responsibilities relate to

specific matters that have been assigned to him by management. Others relate to matters that are an inherent responsibility of the internal auditing function, and do not require specific assignment to the internal auditor; they become his responsibility by virtue of his position. The following are mentioned as examples:

1. System of internal check
2. Company, staff and department policies
3. Company, staff and department procedures
4. Care and storage of company records
5. Care and storage of company property
6. Compliance with external regulations
7. Reliability of accounting and statistical data.

In addition, the internal auditor has the inherent responsibility for keeping management informed on all matters coming under his observation which he feels it should consider. However, he should not undertake to duplicate or usurp the duties of other special controls, if they are adequately reported. For example, he should not concern himself with the development of statistical information or cost analyses, if the departments responsible for furnishing these data are adequately discharging their duties. However, he does have the inherent right to inspect their activities for the purpose of determining the degree of their effectiveness and their compliance with established procedures.

The internal auditor has the inherent responsibility for being alert to the possibility of waste, hazards, and other exposure; and also, for pointing out existing deficiencies, that management may take appropriate corrective action.

While much of the internal auditor's inspection duties relate to accounting and financial activities, current concepts have broadened his inspection responsibility to include many operating functions and other non-financial and non-accounting activities. The extent to which the internal auditor may operate in this direction depends upon his management's understanding of the utility of modern internal auditing practice.

The development of internal auditing to its present high standard, has provided management with a personal and effective means for maintaining contact with field and line operations. It frequently takes a long time to get policies formulated by top management, properly interpreted and working smoothly at the lower operating levels. This is a weakness that exists in many of our larger companies. Likewise, it takes a long time for the thinking and reactions of line employees and lower levels of supervision to filter through the various barriers to top management. The internal auditor,

because of his close association with all levels of management and line employees, becomes a valuable liaison for interpreting policies, smoothing out misunderstandings, and promoting organizational good will. It is activities of this nature that emphasize the internal auditor's need for special training in human relations and communications.

Most of the normal and regularly recurring needs of management are satisfied through special staffs or departments. However, many problems develop which are of such a nature that they do not normally fall within the area of any established department, or are of such a character that their solution would be better handled by an independent agency. Most problems of this nature involve surveys, investigations, or special audits. For example:

1. Request from a supplier for a cash loan
2. Request from a customer for an extension of credit
3. Charges by a supplier for the cancellation of a contract by the company
4. Special audit re: contemplated purchase of related company
5. Propriety of charges made by a sub-contractor
6. Verification of charges made under a cost-plus contract
7. Investigation of inventory losses
8. Survey of shipping and receiving procedures
9. Gathering specific information on internal operations as may be requested by management.

Internal auditing, generally, does not have a "dead-line" for the completion of its various duties, which makes it immediately available to management for such services as may be required. This fact has contributed to its use as a "tool of management."

The utility of internal auditing and the degree to which it may effectively serve management is only limited by the ability of the internal auditor.

The rapid expansion of auditing requirements during recent years, and the general acceptance of contemporary concepts of internal auditing, have found many auditing departments unprepared to render fully the character of service that management needs.

To develop existing audit staffs to the required level of ability, some companies provided staff training programs for their employees. Others prepared suitable material and made arrangements with a local school for its presentation as a special course. To supplement this activity, several chapters of THE INSTITUTE OF INTERNAL AUDITORS conducted study groups for the benefit of its members. Later THE INSTITUTE prepared a course outline for the benefit of those schools and colleges desiring to introduce an internal auditing course. Most of these special courses were developed

to satisfy immediate and pressing needs, consequently they dealt almost exclusively with internal auditing techniques, basic principles, and philosophy. They were developed during the period when concepts were being crystallized and basic standards were being established. Naturally, they did not comprehend the full range of needs as currently viewed. These initial courses served a very important objective, but they did not provide the breadth of training that is now considered necessary to qualify a student for the field of contemporary practice.

Since the contemporary practitioner is required to assume much broader responsibilities than formerly, and is expected to render a far greater range of services, he must be well informed on all business functions and be familiar with their basic principles and objectives. Otherwise, how can he inspect and evaluate their performance? The internal auditor who serves management to the fullest extent, must be qualified to make inspections, reviews, and evaluations at the management level. He must be able to weigh situations in the light of management interests, and arrive at sound practical conclusions. While much of the ability to carry out this broad responsibility must be acquired through actual experiences, college courses can aid materially in preparing the student for this type of practice. The largest factor contributing to the need for college grade courses is the development of responsibilities in the field of constructive services to management. While the rendering of protective services is still an important responsibility of the contemporary internal auditor, his greatest value to management lies in the qualitative character of the constructive services that he may render. The extent of his value in this direction is largely in ratio to his preparatory training.

While the development of internal auditing practice has been largely in the field of private enterprise, parallel developments are now taking place in Federal government agencies. The expansion of government agencies and the complexity of their operations has developed an increasing need for the type of service rendered by the modern internal auditor. The concept of internal auditing as set forth in the "Statement of Responsibilities of the Internal Auditor," and as prevalent in private industry, coincides with the concept adopted by the U. S. Air Force.

Future courses in internal auditing should give adequate consideration to this comparatively new field of service for the internal auditor. The structure and relationship of government agencies, the principles of financing and accounting that they employ, and those special features peculiar to government agencies should be covered sufficiently to acquaint the student with the basic requirements of this particular field of internal auditing.

While considerable stress has been placed on the need for a broad training in business subjects, as support for the internal auditor's technical knowledge, there is another important factor that needs to be emphasized; and that is the trainee—the individual. The degree to which a student's personal qualities are developed has an important bearing on the success he will make of his general and specialized training.

The scope of current practice brings the internal auditor into contact with all classes of personnel from the president of a company down to the office boy, and from factory manager down to the line worker. In addition he is often required to work with suppliers, customers, government personnel, and others. This phase of his work calls for better-than-average contact ability. Much of his work will be concerned with critical inspections, appraisals, investigations, and similar activities, and since it is human nature to be antagonistic to a critic, the successful internal auditor must be well trained in human relations. He must be able to work pleasantly, yet effectively, with all types of personnel. Superior ability in human relations will prove to be a major factor in the advancement one makes in the business field.

Another qualification which goes hand in hand with human relations, is communications; for human relation expresses itself, largely, through this medium. Though this phase of communications is important, the internal auditor needs to be highly trained in this subject for an entirely different reason. He will have many occasions for making oral reports on his work, and will be required to conduct meetings, direct conferences, and address various groups, all of which require the ability to speak well and effectively. However, his prime need for training in communications lies in the fact that the major part of his work—the product of his professional skill—must be conveyed to management through the medium of written reports. If the written report fails to convey to management the intended message in a clear and effective manner, the auditor's value as an aid to management is substantially impaired. More auditors have failed to advance, or have been released, for deficiencies in communications and human relations than because of a lack of technical ability. Lack of technical ability frequently can be overcome with a little practical experience, but it has been the experience of the author that this is not always so in the case of communications. This is a subject that needs major emphasis in all business training programs, but it is especially important to the internal auditor.

Many companies view their internal auditing department as a training ground for future executives, and for this reason select their internal auditors with considerable care, particularly in respect to their educational training.

If internal auditors are viewed as possible potential for future positions of responsibility and leadership, then a college grade course is essential. The curriculum should provide, not only appropriate courses in the necessary technical subjects, but strong basic courses designed to develop the student's personal qualities and a better understanding of the social significance of business and the important part which it plays in our complex economic society. Emphasis should be placed on subjects that stimulate the student's imagination, develop analytical ability, train him to work effectively with other people, and develop an appreciation of the social and economic problems that he will have to deal with.

To adequately meet the problems and opportunities which the field of internal auditing presents, requires a four-year program of carefully selected subjects. The freshman and sophomore years should be devoted to general or basic training and the junior and senior years to developing the student's general business and specialized subjects.

The first two years of basic training could follow closely the pattern prescribed for business administration majors. Without presuming to define the requirements for a basic course, the author is partial to a program that includes at least five of the following, with number 1 as a requirement:

1.	Written and Spoken English	6 credit hours
2.	Biological Science	6 credit hours
3.	Physical Science	6 credit hours
4.	Social Science	6 credit hours
5.	Effective Living	6 credit hours
6.	History of civilization	6 credit hours
7.	Literature and Fine Arts	6 credit hours

Since it is the duty of the contemporary internal auditor to review, evaluate and report on the performance of various business functions, and the adequacy of their procedures and controls, it is necessary that he be trained in as wide a range of business subjects as it is possible to provide. Rather than to pursue a few business subjects exhaustively, a better preparation for the field of internal auditing would result from a greater variety of business subjects, limited to principles, functions, and objectives. It is not necessary for the student to become *highly* trained in all business functions, but it is essential that he be well informed on what they are, how they operate, and what they are designed to accomplish. The use of company organization charts, staff manuals, and flow-charts, will help materially in attaining this objective.

It is believed that many, in considering an internal auditing course, think in terms of pure auditing only, and fail to give adequate consideration to

the need of training for the many other services that are required of the present-day practitioner. Auditing principles that are common to all types of auditing can be adequately covered in one semester; and the principles and techniques peculiar to internal auditing can be covered in a following semester. But this specific training, alone, does not adequately prepare the student for the broad responsibilities he will be expected to assume.

The current needs for internal auditing may be classified as follows:

1. Four year courses arranged to fit the needs of students entering college, with the objective of training for internal auditing practice.
2. Shorter courses designed to suit the needs of business administration or accounting major graduates, who wish to take up internal auditing practice.
3. Special courses for the benefit of employed junior internal auditors, who may feel the need for further training to insure advancement in their work.

In addition to providing for a long-range training program, such as that required for the high school graduate electing to qualify for internal auditing, there is need of courses for employed business administration graduates who wish to enter the field of internal auditing. Such a course might be worked into a two- or three-semester program. The first part of the program could treat with business functions, and a review of the various business subjects covered in undergraduate courses; the second part of the program could deal with basic and common auditing principles; and the third part of the program could concentrate on the theory and practice of internal auditing techniques. Such a program might also be adapted to the needs of junior internal auditors desiring additional training.

At the present time, there is little uniformity in course contents, method of presentation, length of course, and prerequisites. However, this is a natural condition with a subject so new to college curricula. This is a problem that should be resolved at an early date. It will require close cooperation of interested colleges and THE INSTITUTE OF INTERNAL AUDITORS; the professional practitioner, to spell out the needs; and the trained educator, to arrange the detailed program best suited to provide for those needs. Considerable progress in this direction is being accomplished through the cooperation of the American Accounting Association and THE INSTITUTE OF INTERNAL AUDITORS.

THE NEW INTERNAL AUDITING AND THE NEED FOR SPECIALIZED PREPARATORY TRAINING*

By ARTHUR H. KENT
Audit Supervisor, Lockheed Aircraft Corporation

Internal auditing has progressed very rapidly from its original concentration on clerical or accounting routines. Consequently, the modern internal auditor requires a more direct background in his university training to better qualify him for the responsibilities which he must assume.

THE growth of modern business, with its ramifications and complexities, has accentuated the need for men who are not only basically capable, but who have also had specialized preparatory education.

The universities in their regular courses, in their graduate schools, and in their seminars for businessmen are doing a remarkable job in attempting to meet this need.

Continuing new developments in industry are enlarging these demands from year to year. It is no longer sufficient, for example, to think of engineering in general terms. An electronics engineer needs knowledge entirely different from that of the construction engineer.

More and more, business has required trained accountants to gather and portray for management the financial facts of business. And because of the importance of accuracy and proper classification of these data in the financial statements, it has been necessary to train men to examine, analyze, and verify them.

The universities have undertaken, therefore, to train men to be accountants and auditors. As in the illustration of engineers, cited in a previous paragraph, new developments are setting up the need for a different type of auditor with a different type of training from that provided for in the past.

Auditing courses in our universities have been directed primarily to preparation for the profession of Public Accounting—in which the primary objective is the verification of the propriety of financial books and records. Very little has been done, as yet, to prepare men for the profession of internal auditing in its new concept as a branch of managerial control.

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It is the purpose of this article to:

1. Trace the evolution of internal auditing from its original concept of clerical verification to its present concept as an important element of managerial control.
2. Illustrate briefly the quite different objectives and approach of the internal auditor from those of the public accountant in audits usually considered to be in financial areas; and to indicate internal auditing objectives in areas in which the public accountant does not participate.

THE EVOLUTION OF INTERNAL AUDITING

Over the past decade or two there has been a gradual but steadily changing concept of the basic objectives, scope, and services of internal auditing. Today, it is no longer clerical or strictly accounting in nature; it is an important phase of managerial control over business operations.

Although the contrast between the present concept and that of the early years of internal auditing is sharp, it has evolved slowly in a series of logical steps. Broadly, there have been three recognizable major steps in this evolution; but even in these, the lines of transition were not sharply defined. The three stages or major concepts of the function of internal auditing might be described as follows:

1. The verification of the mathematical accuracy of various accounting figures, with particular attention to cash matters; reconciliations of bank accounts, audits of payrolls, check of approvals on documents.
2. The verification of the accuracy and propriety of the company's accounts and financial statements. This was a more detailed, but essentially similar type of auditing to that performed by the outside accountants.
3. The adoption of a top management point of view—rather than a strictly accounting one—in all areas under examination. The logical effect of this change of viewpoint was to extend gradually the scope of verification, inquiry, and appraisal into areas of business beyond those usually designated as accounting.

So that commencing largely as a purely clerical function—a double-

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ARTHUR H. KENT *was born and educated in England. He is with Lockheed Aircraft Corporation and was formerly General Auditor, Standard Oil Company of California. Mr. Kent is a speaker and lecturer of note; he has lectured at several of the leading universities in his home state of California and has written extensively for publications of various professional societies. He was honored with the first Thurston award for his article "The Profession of Internal Auditing."*

Mr. Kent is a member of THE INSTITUTE OF INTERNAL AUDITORS *and is presently serving* THE INSTITUTE *as Chairman of the Research Committee.*

checking of accounting computations and postings—it passed through a period in which it also operated along lines similar to those of the outside accountant, and is now emerging into a service and field of activity distinct from that performed by anyone else, either within the company or outside of it.

Prior to describing the steps by which internal auditing arrived at its present concept, certain general statements should be made.

The progress of internal auditing has varied by companies. In some companies, it is even at the present time in what we have described as the second stage of evolution—auditing in approximately the same areas as those of the outside accountant. Others, while adopting a certain amount, at least, of a managerial viewpoint, have not extended their scope beyond financial accounting matters. Again, others are full practitioners of the concept recognized in THE INSTITUTE OF INTERNAL AUDITORS "Statement of Responsibilities"—that internal auditing may properly deal with matters of an operating nature.

It must be recognized, however, that there will always be a number of factors that will prevent an absolute uniformity in the scope of internal auditing as between companies. Perhaps, the primary cause of variation will be due to different points of view of the top management of companies. Some will encourage extension of scope; others will place limitations on it. In some companies, special organizational groups, independent in status and hence objective, may carry on surveys which in other companies are assigned to the internal auditing group.

The fact remains, however, that whatever growth in usefulness and recognition is to accrue to internal auditing, and whatever fulfillment of its claims to being a distinct profession is to take place, must come about through the concept of its being an integral portion of managerial control, not an accounting activity. And this viewpoint is definitely growing.

This, however, does not mean that internal auditing has deserted the financial field for something which at times may approach management engineering. It does not mean that in expanding its area of usefulness it has parted company with its earlier concepts. It includes them, has added to them, but changed its slant and stress point.

It will still interest itself in mathematical accuracy, it will still be alert to cash manipulations, and it will still verify the propriety of accounts and financial statements. However, its basic concept of rendering every possible constructive aid to top management logically forces it out into fields beyond those found in the accounting department.

MANAGEMENT RESPONSIBILITY AND NEEDS

A primary function of management is to control and coordinate the various activities for which it is responsible into a unified endeavor, so as to produce a successful end-result. In addition to basic administrative ability, it must have the necessary tools; and one of the greatest of these is complete and accurate information as to each activity.

The information as to financial results is supplied by the accounting organization. Management, however, needs to know something more than these; it needs to know whether such results are as good as should have been expected.

It therefore requires close-up pictures of operations—information as to whether established policies and programs are actually being followed, whether proper controls have been established, and are effective, whether supervision is intelligent and alert, and similar criteria of a sound business operation. It needs all the knowledge it can obtain in the interests of intelligent and strong control of the entire business activity.

In addition to the information as to such matters which filter up through line supervision, it needs the services of independent staff men, who are objective in their viewpoints, who will examine activities at the source, and furnish unbiased appraisals of their findings and opinions.

That is the field into which the internal auditor working under the newer concept is being fitted, and for which he needs all the preparatory training he can obtain.

CONSIDERATIONS GRADUALLY LEADING TO THE PRESENT CONCEPT

It has been stated previously that this evolution in concept was a natural and logical one—one move pointing the way to the next, slowly but steadily.

Internal auditors were rendering a service to their companies in checking and verifying financial statements and their underlying data. And they possessed, or acquired, certain skills in performing this work. It was simple common sense then, that if management was desirous of assurance that accounting records and statements were reliable, it also needed assurance that statistical data and statements furnished to it (and on which managerial decisions and future plans depend) were similarly reliable.

Obviously many of these operating statements are based on data provided by non-accounting people; hence, their validity required particular verification. If the internal auditor could render a service by analyzing accounting data, it was quite logical that he should apply similar techniques to non-accounting material. So, here and there, a few internal auditors began to

examine the underlying data of non-accounting statements, and the practice began to spread.

Then, since it had been considered that the appraisal of accounting policies, procedures, and practices was properly within the useful service of the internal auditor to management, it was logical that he should recognize that his appraisal of similar matters in non-accounting areas would also be of value to management.

The managements of various companies where internal auditing was being broadened in scope began to recognize its potential value to the company and encouraged it—and further possibilities were at the door of the internal auditor.

And so, step by step, the scope of his activities widened. No spectacular, overnight transition took place; but as each new area was entered and useful work accomplished in it, the opportunity was offered to move on slowly and carefully into still other phases of company activities. This cautious extension of internal auditing services was successful and sound in principle.

THE EFFECT OF THE CHANGED CONCEPT ON INTERNAL AUDITING STAFF REQUIREMENTS

This ever-widening scope of activity, this movement out into areas beyond the accounting field, began to spotlight the fact that a somewhat different set of qualifications for internal auditing was necessary.

The education which fitted a man to audit financial statements and records was not sufficient in itself to equip a man for the broader areas. The habits of thought and the mental approach of the internal auditor, who was to practice the new concept successfully, had to be different. Considerations and perspectives would need to be those of a manager rather than those of an accountant.

Certainly, a capable accounting department can be of inestimable value to top management in portraying the financial status of the business, and in furnishing analyses of various aspects of it. Many other matters, however, are of vital concern to management, and demand its time and serious thought. The soundness and practicability of the company's policies, the quality and quantity of production and sales, the relations with personnel, and the overall efficiency of the many and varied detailed activities of the business—all these are integral factors of successful management, and must receive their proper proportion of management attention.

This then was the broader, more highly ramified and complicated world into which the internal auditor was to venture. In order to be of any real value he must consider and evaluate everything that comes within his obser-

vation with the vision and sense of values of a top manager. His mental processes and reactions must parallel those of the top men of his company.

The specialized background and areas of activity of the accountant did not, of course, disqualify him for this new and broader activity. Such training could be of great value, provided that he had the type of mind that could grasp and absorb this broader viewpoint, and provided that he would equip himself with whatever additional education was necessary. Actually, the larger proportion of the men, who today are practicing the widened scope of internal auditing have been drawn from the ranks of men trained in financial auditing.

Internal auditors who are trained to practice successfully in this broad field have unique opportunities of learning the basics of business management and becoming acquainted with the detailed aspects of the business itself. Such a broad education should enable them to move upward in the business world.

ILLUSTRATIONS OF MANAGEMENT-VIEWPOINT AUDITING

In an article such as this, it would be impossible to furnish a list of all audits in which the management point of view can be injected, in addition to the verification one. We have therefore selected four in areas which are familiar to the public accountant, and have indicated briefly the differing objectives which the internal auditor seeks to achieve. In addition, we have briefly discussed areas of business operations in which the internal auditor may engage, but which—except under extraordinary circumstances—would be completely outside of the public accountant's field of work.

These illustrations should serve to contrast the activities of the internal auditor and the public accountant.

FINANCIAL ACCOUNTING AREAS

Accounts Receivable. The internal auditor will not merely verify by circularization the existence and accuracy of the receivables shown on the books. Since it is a matter of vital interest to management, he can seek to determine as a part of the program of confirmation letters, the opinions of customers as to the service furnished by the company in both operating and accounting matters. In addition he can examine the correspondence files, to determine whether requests or complaints have been handled promptly, courteously, and intelligently.

It may be that although the account balance at the time of the verification is correct, too many mistakes have been made over a period of time in invoices, credits, etc. All such mistakes irritate customers, and undermine those good relationships which are essential to a continuity of business.

Credit Admission. The internal auditor will not be concerned alone with the aging of accounts and the propriety of reserves for bad debts. He will seek information as to the manner in which credit policies have been administered. Has there been laxity in observance of policies or collection effort? Has there been over-rigidity in applying policies, which has hindered legitimate sales efforts? Has credit correspondence been of such a nature as to effect collections, without at the same time creating unnecessary ill-feeling? In other words, has there been a proper balance of collection aggressiveness and good judgment?

Invoices and Statements. Are they issued promptly as well as accurately? Dilatoriness may not only delay collections for a few days; in some instances customers who are short of money may work on the basis of first come first served for the current month. Inaccurate invoices and statements inevitably irritate customers, and produce bad publicity.

Inventories. The internal auditor with a management slant will do more than observe physical inventories, reconcile them with the books, and see that the adjustments are reasonable.

It may be that for various reasons there are a large number of discrepancies both in quantities and in dollars; but inasmuch as they consist of both overs and shorts (in many instances totally unrelated), sizable gross differences in values "net" to an amount which comes within a generally accepted tolerance from an accounting standpoint.

Such a condition would indicate inaccurate ledger work, or poor stores documentation, and a general condition quite unsatisfactory to management from an efficiency standpoint—all this, despite the acceptability from a write-off standpoint. Furthermore it might be that a thorough investigation of differences (both over and short) might reveal quite unsatisfactory practices.

Again the internal auditor will inspect stores housekeeping conditions to determine whether they were such as to produce prompt shipments, etc. These are matters of considerable importance to management, although not directly connected with accounting.

In addition, he will determine that policies applicable to such matters as time storage limitations are being observed. (Certain articles will deteriorate, and should be used first in, first out; otherwise it may be necessary to scrap them.)

NON-FINANCIAL ACCOUNTING AREAS

There are many departments in a company in which records of activities are not a part of the chain of data which ultimately is given effect in the Financial Statements. Some of these records may affect financial data in-

directly; a larger portion of them are the mechanisms by which the flow of operations is controlled. Many of them do not contain any recognition of dollars. They are records of what operations have taken place, whether they are on schedule or not, volume of work performed, results versus expectancies, etc. Some of them inform immediate supervision only; others reach higher management.

Each such department has responsibilities, policies, programs and detailed procedures. These need review as to soundness and adequacy. The satisfactoriness of performance needs review.

In these departments day by day the many and varied detailed operations of the big business machine are performed. Top management has little opportunity to scrutinize these detailed activities that produce the condensed reports it receives. Certainly, then, objective examinations and appraisals by men trained in analytical work and independent in status are of value to management.

Because of the variety of such activities in varied industries, and the varied desires of particular managements, it is only possible in an article such as this to indicate the general nature of such audits by a few illustrations—and even these can but be sketchy.

PURCHASING

In every company there is opportunity to examine the purchasing activities. Such an examination would seek to offer to top-management an objective appraisal of these extremely important activities.

Analyses would be made to determine whether purchasing policies were being carried out; whether the department had developed and was making use of records furnishing complete data as to sources of supply; whether procedure has been developed and were being followed strictly in the matter of placing orders without favor—through bids, etc.; and whether there were proper working relationships with other company departments.

In summary, these studies would seek to offer an objective appraisal of the entire purchasing department activity. Since it represents the ultimate expenditure of a very large proportion of company funds, it is extremely important to top-management to know whether it is controlled to the extent expected.

FACTORY OPERATIONS

In a large factory, management must depend to quite an extent on various reports of a non-financial nature to exercise control over both efficiency and cost. The accuracy of these data requires independent verification to

determine their reliability. The internal auditor must gain an understanding of operations before he can pass on the validity of the reports. Again there is a vast mass of paper which controls the status of work and the movement of material and of fabrication processes. Lack of good systems, inaccuracies, unintelligence, and lack of timely compilation of records may bring about costly tie-ups or outright losses. There may even be a parallel in these areas to financial manipulation; *i.e.,* improper information deliberately furnished in order to cover an unsatisfactory situation. An objective, intelligent appraisal of such matters will be of considerable assistance to management.

OTHER AREAS

Rather than attempt to detail the many areas in which the internal auditor may be useful, and the objectives sought, it might be sufficient to suggest that they could well include such varied matters as:

Personnel Administration including Wage & Salary policies
Receiving, Shipping, and Inspection activities
Efficient use of Company product containers
Special analyses of product losses
Reclamation activities
Analyses of surplus stocks—propriety and cause
Tool control

CONCLUSION

The wide scope of activities and the managerial approach to examinations of them should indicate clearly that the internal auditor is operating in a field that is distinct from that of the public accountant. It follows then that his professional equipment must be different, that his preparation, background, and the atmosphere in which he thinks must more nearly approach that of a manager rather than that of an accountant.

As he carries on his activities he will acquire constantly more and more knowledge of business operations, but from a "managerial" rather than from an "accounting" viewpoint. It seems logical, therefore, to believe that he will progress faster and more soundly if he has been trained in his university days along these lines.

We have a sympathetic recognition of the constantly increasing demand on our universities for specialized training for this and that activity. We recognize that there is only so much that they can do. We do, however, suggest that whatever can be done to inject into the curriculum some helpful preparation for the growing demand from industry for management-minded internal auditors will be a worthwhile contribution.

Perhaps at the outset it will be simply an amplification, and a changed slant in auditing courses, so as to aim them at the broader industrial needs, as well as at public accounting. Perhaps there might be included refresher courses in the practical aspects of personal relationships (a very important factor in this changed internal auditing) and in the techniques of survey reports—intended for busy, practical operating management. Beyond this, time and experience will dictate broader horizons.

Internal auditing today is an interesting, intriguing field. It is providing something distinct and valuable to business management. It requires capable and properly prepared men.

OBJECTIVES OF INTERNAL AUDITING*

By M. B. T. DAVIES
Booz, Allen & Hamilton

Success in business means expansion, and expansion requires delegation of authority to meet carefully planned long-range programs. The author explains general and specific objectives of internal auditing—in relation to the requirements of business and the responsibility of the internal auditor.

TO conduct a successful business, the management has to specify objectives; lay plans to meet them; allot responsibilities and authorities; set standards of performance; and evaluate results. And to permit it to keep its grasp on the affairs of the business; to devote its primary attention to policy-making and planning; to confine its participation in routine affairs to those areas only where special attention is needed, businessmen have evolved the concept of "management by exception." By this they are able to focus their attention on high-level matters, the unusual, and the troublesome.

It is within this framework that internal auditing comes into being. As a service to management, its mission is: (1) to assure management that the controls are effective, both in operation and as media to identify and reveal matters needing management review; (2) to bring to attention instances where the controls fail to meet these needs; and (3) to act on management's behalf as an instrument of check on various aspects of the business controls.

CONTROL

In the small business, where formal internal auditing is not economically justifiable, the objectives of internal auditing are attained by management

* Reprinted from The Accounting Review—April 1956.

itself exercising a check on its controls. As the business expands and operations become more complex, the management delegates this function, as it does others (purchasing, traffic, industrial relations, advertising, etc.), to a specialist group.

The basic function of the internal auditor, then, is to act on management's behalf as a check-point on the business controls. These controls, commonly known as "internal control," have been described as ". . . the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies." It is of interest to note that the concept of business control expressed by this leading body of accounting thought recognizes a much broader field than that of accounting or auditing alone. The promotion of operational efficiency and the adherence to prescribed managerial policies are specified as essential and integral features of business control.

Internal auditing is "the independent appraisal activity within an organization for the review of the accounting, financial and other operations as a basis for protective and constructive service to management. . . . The overall objective . . . is to assist management in achieving the most efficient administration of the operations of the organization. . . ."

Historically, the major effort of internal auditing has been devoted to accounting and financial data. Perhaps the reason is that those data are more susceptible to numerical checks, a form of checking which produces the most easily understandable results. Perhaps, too, the process of figure-checking on an independent basis is an earlier development—dating back to biblical times and even before—and, as a consequence, was more highly developed, widely recognized, and therefore more readily accepted by business as a means toward checking its controls. Nevertheless, recent trends bear witness to the fact that internal auditing is becoming more generally accepted as a means of checking internal control in its wider and more modern interpretation.

APPRAISAL OF CONTROL

Internal auditing is an appraisal activity, ". . . a type of control which functions by measuring and evaluating the effectiveness of other types of control." This appraisal is best performed if the auditor is independent of the other types of control, thus bringing to bear an unbiased attitude toward each phase of the activities that he reviews.

The activity has been classified in two segments:

1. Constructive—to promote improvements in operational efficiency through the review and appraisal of
   a. policies and plans
   b. records and procedures
   c. performance.
2. Protective—to insure the adequate functioning of the controls, including recommendation of remedial measures, by ascertaining the degree of
   a. reliability of data (including accounting)
   b. protection of property
   c. compliance with policies, plans, and procedures.

Here, then, lies the field of the internal auditor. It is as wide as the activity of the enterprise itself. It covers all the areas in which management itself plays a part, and from there it delves into the implementation of management decisions. Viewed from the management aspect, it may be categorized in the form of a questionnaire to which the auditor is expected to produce answers.

1. Objectives
   Are our policies sound? Are they being properly transmitted and followed?
2. Plans
   Are our plans sound? Are they being properly transmitted and followed?
3. Organization
   Are responsibilities and authorities being allotted effectively? How good is performance?
4. Standards
   Are our standards of performance reasonable? Are they being properly conveyed to those affected?
5. Appraisal
   Are our records reliable? Is performance gauged in the light of these records so as to maintain high standards of efficiency?

MAURICE B. T. DAVIES *has held the positions of auditing manager, accounting manager and assistant controller. He has also been engaged in the practice of public accounting, and served during World War II with the combined Chiefs of Staff Organization.*

Mr. Davies is a member of the Institute of Chartered Accountants of England and Wales, the American Institute of Accountants, and THE INSTITUTE OF INTERNAL AUDITORS.

THE AUDIT OF BUSINESS OBJECTIVES

Management policies represent the objectives of the business and the framework and philosophy surrounding the conduct of that business. At each successive level of managerial delegation the policies will usually consist of a mixture of some part of the top management policies combined with a plan or subsidiary objective delegated by the next senior echelon. As an example, "the purchasing of materials, services and supplies in the most appropriate quantities and qualities, at the most economic prices and at the right time" may well constitute a part of the policy of the procurement function. Yet, as likely as not, it may receive no mention in the formulation of top management's obectives and policies, since it is a matter of common business practice that such a policy be followed.

The internal audit staff must be well acquainted with management objectives, for it is clearly impossible to insure compliance with policies unless they are known and understood in the first instance. The auditor's own objectives in this field are threefold:

1. to become acquainted with management policies;
2. to see that they are properly complied with;
3. to appraise the policies themselves.

This sequence may at first seem illogical. Why, the auditor may ask, should we not appraise them first and then see that they are duly followed? The answer to this may be the old adage that "the proof of the pudding is in the eating." The auditor, after all, is generally a less experienced man than those who define policies. To him a given policy or objective may appear questionable. However, his appraisal activity will involve reviewing that policy through the various levels of management and observing its practical implementation and results. The procedure will be the most effective method of determining whether or not (a) the policy itself is sound; (b) it is being implemented according to plan; (c) it produces effective results.

THE AUDIT OF BUSINESS PLANS

With the objectives formulated, measures have to be adopted so that they can be put into execution. These measures constitute plans. In their broadest sense, plans represent the expansion of a business objective, defined for the use and guidance of a lower level of management. In a narrower sense they consist of a more precise course or courses of work to be done to attain the desired objective. This latter concept gives rise to the establishment of working procedures.

With his responsibility for assisting management in achieving the most efficient operational administration, the auditor must concern himself closely

with the appraisal of plans: constructively, to see that they are designed in the best interests of efficiency; protectively, to insure that there is proper compliance. Audit objectives in this area may be described as follows:

1. to become acquainted with the plans;
2. to insure that the plans correspond with the related objective;
3. to see that they are properly complied with;
4. to appraise their soundness, based on the foregoing.

Effective auditing is more likely to be attained if the auditor emphasizes in his approach the paramount importance of the objective as contrasted with the plan or the procedure. Good judgment often dictates a deviation from a plan or procedure in order better to achieve a desired objective. Rigid adherence to an established plan or procedure may be unsound, particularly if circumstances have changed or if the plan or procedure was not originally designed in a manner to produce the best result. Deviations from plans and proceedings must, of course, receive audit attention. They may be symptomatic of bad performance, poor communications, or impractical plans or procedures.

The auditor must be alert, in his review of plans, for chain reaction. Since the functions of a business enterprise are departmentalized, generally in line with the allocation of responsibilities, any apparent weakness or any change in plans or procedures may have a multiple effect organizationally. As he should be acquainted with the over-all organizational and functional structure, the auditor is in an excellent position to judge these impacts. He should be qualified to determine those cases where procedural weaknesses should be accepted because correction would cause even greater weaknesses in the plans of other departments or functions.

In this area, too, it becomes abundantly evident that the value of internal auditing to management is enhanced by engagement in an appraisal activity that extends over all the functions of the enterprise, as contrasted with that type of audit activity which is narrowly restricted to the accounting and financial functions.

THE AUDIT OF BUSINESS ORGANIZATION

In its "statement on internal control," the American Institute of Accountants stresses the importance of a sound plan of organization as a means toward the operation of effective control. "The size and scope of the present-day enterprise," it states, "is such that in most cases executive management can no longer exercise personal supervision over the conduct of operations. Under the circumstances the establishment of a suitable organizational structure is essential. . . . Generally, a satisfactory plan . . . must lend itself to the establishment of clear lines of authority and responsibility."

Modern business depends increasingly on mechanization. Mechanical devices are capable of producing both work and information, thus eliminating human effort. But the motivating force behind business and the mastermind that directs the machines must always remain the human being. It is the direction of men and women, with their varying skills and capacities, the regimentation of their efforts into missions, and the coordination of these missions into a cohesive plan that constitute business organization. While there are many principles that may guide the structure of a business organization, the application of these principles can give rise to varying structures. And, since one of the most significant objectives of organization is to produce optimum results from the combined efforts of a group of men and women, good organizational principles may often have to take second place to consideration of individual capacities and peculiarities.

The objectives of the internal audit staff in appraising the organizational plan must necessarily be to insure that it is so devised as to produce the most effective results. The appraisal will consequently embrace such features as:

1. becoming acquainted with the organization structure;
2. insuring that it is in harmony with the over-all objectives and plans;
3. evaluating the logic and effectiveness of the allotment of responsibilities and delegation of authorities within that structure;
4. assessing the soundness of the organization as a result of reviewing it in operation.

The marshalling of human effort which we know as the organizational structure has a vital impact on business operations. It has its constructive aspects, from the viewpoint of attaining optimum results, and its protective aspects, from the viewpoint of producing a proper degree of check and balance. It is an area where the organization chart represents merely a skeleton, complete only with the muscle, provided by a clear understanding of responsibilities and authorities; from misplacement or ineffective performance of the men and women who build the structure. It is a wide field, indeed, for the auditor to cover, but one that must necessarily come within the sphere of his review, having regard to its essential bearing on all phases of operational performance.

THE AUDIT OF STANDARDS OF PERFORMANCE

In our discussion we have encountered one word time and again—"effective." To produce desired results, all effort, both human and mechanical, must be effective. One machine may be effective if it produces an article to one-tenth-of-an-inch accuracy; another may be effective only if it produces with an accuracy of one-ten-thousandth-of-an-inch. One salesman

may be effective if he produces a volume of $10,000 of sales a month; another may need to produce $100,000 a month. These factors have to be predetermined. If machine accuracy or productivity is not defined, the machine may produce sub-standard results or, just as undesirably, do better work than is needed at an uneconomical cost. And the same applies to people. Moreover, unless standards are set, there is no measuring device for appraisal of results.

The formulation of standards is an integral part of a system of control. It is a part of the composite plan which enables results to be inspected and reported so that the practice of management by exception can be operated efficiently. Management executives will be spared the task of attention to matters to which their time need not be devoted, thus freeing them for more important duties.

It is well to emphasize, too, that there are all too many cases where predetermined standards are either insufficiently defined or else non-existent. This opens an area for the internal auditor. He can point out the disadvantages of attempting to operate without standards and assist in their installation by making preliminary appraisals before they are used as working tools.

For the auditor, whose function is one of appraisal, standards become an important working tool. The very act of appraisal implies a measurement. And how can he measure without a yardstick? And furthermore, should he not know that the yardstick itself provides a fair tool for the measurement process? The conduct of his review activity in this field should therefore include attention to such points as the following:

1. becoming acquainted with the standards of performance;
2. examining their build-up to insure that they are scientifically and intelligently devised:
3. insuring that they are reviewed and, where necessary, modified to meet changing conditions;
4. seeing that they are duly conveyed to, understood by, and accepted by the units and people whose efforts they concern.

In this particular area the auditor's activities fall more within the "constructive" than the "protective" category. As support for this contention one might cite these facts. If standards are unduly high, morale may become unduly low and work will suffer. If standards are not high enough, work will be accepted which is less than fully effective and potential profits will be lost by default. Even if standards are realistic and work meets these standards, it may be possible to upgrade both the standards and the work—and consequently the profits—by devotion of intelligent and scientific examination to the underlying work factors and processes.

THE AUDIT OF APPRAISAL OF PERFORMANCE

Success is gained by performing effectively and by consistently improving that performance. In a world of intense competition a high standard of performance in one year may be grossly inadequate a few years later because of advances in competitive practices. Business management is constantly faced, therefore, with such questions as: "Did we do as well as we expected?" "If not, what was wrong and how can we cure it?" "If we did better, how did it happen and what can we do to sustain that performance?" "Even though we did as well as expected, is there not some way of doing even better?" "How do we rate compared with competition?"

These questions are—or should be—asked and answered at all levels of management. They can be answered, however, only as a result of factual information, the comparison of known results against predetermined standards coupled with a review of the reasons for departures from the norm, and a continuing study of means to improve performance.

This judgment or appraisal can, broadly speaking, arise from two types of inspection, inspection of things and inspection of data. Quality control is a familiar example of the first type of appraisal. It generally involves the physical inspection of a product to insure that it meets specifications. The second type of appraisal is more complex. The events themselves are too abstract to respond directly to inspection. A process of interpretation is first required, a process which commonly results in the expression of what has happened in terms of numbers, that most uniformly understood language. This numerical interpretation requires the use of highly trained skills, imagination, and judgment. Any one set of events may be capable of different numerical interpretations, probably all equally correct according to the underlying concepts adopted but depending on the judgments of the various interpreters.

We find two professions predominant in this complex field, the accountant and the engineer. Based on their directions and judgments, statements of data are compiled upon which appraisals can be founded. In addition to the accountant and the engineer, we find the internal auditor, who is here confronted with the task of appraising from a control viewpoint the activity of appraisal of performance. His principal objectives in this area will be:

1. to find out what data are being used;
2. to assess their reliability and, where necessary, to assist in recommending remedial measures;
3. to ascertain that the data can be and are being used effectively.

In performing this function, the auditor must review other appraisal activities already in operation. These may be described as "quasi-audits."

If he finds that they are operating effectively, he will be able to reduce the intensity of his review in these areas. Quasi-audit activities are commonly encountered in such departments as cost analysis, budget statistics, and operations analysis; and in certain functions performed by the accounting department.

There are many areas in this phase of auditing which could profitably receive study. However, let us confine our consideration to a few aspects of everyday business interest.

1. Accuracy. Only by the provision of reliable data can there be a reliable appraisal. Inaccurate data can give rise to erroneous appraisals and, as a result, abortive action based on the consequent ill-founded decision. Appraisal of the reliability of the data has, of course, always been a predominant objective of the internal auditor.
2. Timeliness. Appraisals of performance are a step toward better performance. The sooner better performance is achieved, the greater will be the profits. So the underlying data are required speedily. Moreover, the sooner they are available, the more likely will there be an intelligent appraisal because the facts are still of recent memory.
3. Presentation. The method of conveying data to those who use them may have an important effect on their appraisal and decision. By highlighting the significant and de-emphasizing the commonplace, the data-reporter can both save the appraiser's time and assist him in distinguishing between the important and the unimportant. However, care must be taken to insure that each report conveys a complete picture.
4. Reasoning. Bare figures and facts presented to the appraiser may put him in a position where he has to gather more facts. The presentation of data *coupled with reasons* for significant features will do much to facilitate the appraisal process.
5. Interpretation. Poor business decisions can arise from faulty interpretation of data. A common cause for this is overdue confidence in the reliability of statistical and accounting data, which necessarily reflect *one* interpretation of operating results. The arbitrary allocation of overheads and the values attributed to inventories are examples of areas where data should be critically reconsidered before being accepted as a basis for decision and action.

THE FUTURE

During the past few years we have witnessed a most significant metamorphosis in the scope and practice of internal auditing. Once the field of a drudge who restricted his activity to little more than voucher checking and

examining the books of account, its range has been extended so greatly as to present a field of endeavor that is almost frighteningly broad.

This broadening of scope has imposed a heavy responsibility on the internal auditor. While a thorough background of accounting is still essential, he is able to function effectively only if his accounting training is supported by sound business experience and by the ability to make effective use of the efforts of men with technical (non-accounting) backgrounds in conducting his audits. Some business organizations are now bringing such men as industrial engineers into their internal audit staffs. With the growth and expansion of audit concepts, this trend will undoubtedly become more prevalent. Yet it is probable that the accountant will continue to play the predominant part in internal auditing. His specialized training in the tools used by business to evaluate their results through numerical devices; his familiarity with the protective measures needed to safeguard property, funds, revenues, and profits; all these factors combine to qualify him to play a leading role in serving as "the eyes and ears of management."

Quotations in this article are from American Institute of Accountants' 1949 "Special report by the Committee on Internal Control" and Institute of Internal Auditors' *Statement of Responsibilities.*

ARTICLES OF INTEREST TO INTERNAL AUDITORS

Subject: AN UNEASY LOOK AT PERFORMANCE APPRAISAL

By: Douglas McGregor, Professor of Management, Massachusetts Institute of Technology

Published in Harvard Business Review, May-June 1957

In this article Mr. McGregor brings out that the conventional approach to performance appraisal by supervisors stands condemned as a personnel method. The executive making the appraisal is placed in the untenable position of both "judge" and "jury" over his subordinates.

It is suggested that a new plan—not a compromise—be adopted. The plan proposed is to place the responsibility on the subordinate to establish goals and, to himself, appraise progress towards these goals, both short- and long-term. In the process the subordinate "gains a genuine sense of satisfaction, for he is utilizing his own capabilities to achieve simultaneously both his objectives and those of the organization."

The supervisor enters the process when specific plans for goal accomplishment have been laid; his role becomes one of coordinator and guide or coach rather than "judge." This method shifts the emphasis from appraisal to analysis for the constructive good of company and employee. The result will be greater motivation and more effective development of subordinates.

Subject: STANDARD COSTS—HOW THEY SERVE MODERN MANAGEMENT

By: Clinton W. Bennett, Senior Partner, Cooley and Marvin

The effective development and application of standard costs requires that the standard cost program be a three-way effort among management, engineering and accounting personnel. Under this assumption, this book follows the procedures of a cost consultant in working on a firm's problems.

With liberal use of case illustrations, the various chapters cover such topics as Standard Costs and Their Relation to other kinds of Costs; Organizing the Business for Effective Controls; Setting up the Order and Planning System; Designing the Cost and Accounting System; Developing the Cost Formula; Preparing the Budgets; Determining the Standards; Rewarding the Worker; Developing Current Cost Information; Cost Variances; Statements and Reports and Profit Planning.

Prentice-Hall, Inc.
70 Fifth Avenue
New York 11, N. Y.
Price $10.65 515 pages

Subject: RECORDS RETENTION AND CONTROL

By: Jewel Moberley, Elizabeth D. Holbrook, William L. Rofes, Herbert F. Klingman for the Controllership Foundation, Inc.

The records experiences of thirteen companies are described in detailed case histories in this book. The selected records management programs, provide a cross section of industry, location, company size and volume of records. Details are given of the background and organization of each company, so that records objectives and problems may be easily understood by the reader. Answers are given to such questions as: (1) where organizational responsibility should be located (2) when should the services of consultants be used (3) what is the logical order of records operations (4) what information is needed for "records inventory" and how is it compiled (5) what appraisal and analysis standards should be followed (6) what are "vital records" (7) when is microfilming cheaper than storage (8) what type of storage equipment is best.

Statistical data, schematic diagrams and appendices are included to help visualize clearly the situation in each of the companies whose programs are described.

Warnings as well as possible solutions for the records management programs can be learned as applied to your company from the experiences of others as outlined in this book.

Controllership Foundation, Inc.
2 Park Avenue
New York 16, N. Y.
Price $7.50 455 pages

Subject: INTERNAL AUDIT IN LOCAL AUTHORITIES AND HOSPITALS

By: W. L. Abernethy

This book, published in England, is concerned with the control and internal audit problems of various local authorities, and as education, housing, hospitals, parks, police, courts and other publicly-operated facilities.

Beginning with some general thoughts on the function of internal auditing—as distinguished from public accounting—Mr. Abernethy goes on to describe the responsibilities and methods of operation of internal auditors. With this as background, the various specialized fields of operation are described, showing the statutory requirements, the usual controls and the functioning of the internal auditor in each field.

As is to be expected, certain specialized situations exist—as compared with the United States—because of the operation of the National Health Service and similar plans. In general, however, these have comparatively little effect on the major part of the control and audit requirements.

Shaw & Sons, Ltd.
Fetter Lane
London E C.4
Price 37 sh. 6d. 374 pages

Subject: AUDITING AND ITS DEVELOPMENT IN UNITED STATES STEEL

By: W. R. Davies, Director, Audit Division of United States Steel

Published in The Federal Accountant, March 1957

Twenty years ago, the internal auditing activity of U. S. Steel was principally concerned with payroll. Today the audit division has "full and free access to all departments and records with respect to the locations audited and there are no restrictions on their audit activities."

Mr. Davies describes the essentials in planning and execution which have been followed in fulfilling the broad assignment of responsibility which has been given by management. Particular attention is given to the importance of functional and operational audits and their relationship to good management. Through experience gained in regular assignments, and through general familiarity with the review and analysis of records and reports, the auditor can work just as well with operating records as with the financial records that have been his traditional field.

Subject: COST ACCOUNTING

By: Charles F. Schlatter, Professor Emeritus, University of Illinois
William J. Schlatter, Professor of Accounting, University of Michigan

This new edition of a standard text stresses the managerial purposes of cost accounting. In management's view the control of cost is a chief purpose of cost accounting; consequently, the effort is to emphasize principle more than procedures.

The book includes consideration of such matters as direct costing, accounting for distribution costs, the effect of volume on costs and profits, control of factory overhead costs and flexible budgets. Each chapter concludes with problems and questions of varying lengths and degrees of difficulty.

John Wiley and Sons, Inc.
440 4th Avenue
New York 16, N. Y.
Price $7.25 725 pages

Subject: THE INTERNAL AUDITOR AND ELECTRONICS

By: Charles E. Grody, General Auditor, New York Life Insurance Company

Published in Systems and Procedures, May 1957

As the applications of electronic data processing increase and become better established, there will be greater need than ever for ingenuity on the part of the internal auditor. In this article, Mr. Grody describes the application of the equipment in his company and the resulting questions that have arisen in relation to internal auditing operations.

Electronic equipment takes over "many repetitive and time consuming tasks thereby releasing people for more creative and interesting work." This thought can be applied both to the line operating personnel and the internal auditing staff.

Subject: **BETTER REPORTS FOR BETTER CONTROL**

By: **John G. McLean, Vice-President, Continental Oil Company**

Published in Harvard Business Review, May-June 1957

In this article is described the evolution of a program of meaningful reports for a large oil company. Beginning with 12,000 figures that comprised the previous structure of reports, careful study and evaluation of the necessity and value was made, to the end of developing a plan of control reports that would bring out the salient features of the company's operation.

Particular emphasis was placed on "control" reports which presented a combination of accounting, financial and operating data on a current and comparative basis for each major company operation, together with summary figures for the company. These reports form the basis for meetings with department managers and regional management group. Where the complaint was made that "the figures don't mean anything," the complaining department was requested to help in developing more meaningful figures.

Through the use of the control reports, there is being developed an accepted series of performance yardsticks. Attention is focused on current and chronic problems. The review meetings provide direct contact and suggestions, minimizing staff analysis work. Finally, the control reports keep management adequately in control as the company expands and becomes increasingly decentralized.

EMPLOYMENT SECTION

This employment section is offered as a service to members and others who may be seeking employees or who may be interested in new employment. All replies should be addressed to the advertiser—if the name is given—or addressed to The Institute of Internal Auditors, 120 Wall Street, New York 5, N. Y., with reference to the Box "E" number. Space rate on request.

SITUATION WANTED

Internal Audit Manager—CPA—N. Y., AIA, 35 years old, college graduate. 8 years internal auditing and public auditing experience, Box E. 178.

SITUATION WANTED

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Large food company, multi-plant operation, has an opening for staff auditor. Development to managerial responsibilities. Degree required plus three years experience in auditing. About 50% travel with most weekends at home. Relocation at company expense to either Kansas City, Mo. or Cleveland, Ohio. All company benefits including Profit Sharing Plan. Salary to $600 per month to start. For interview send résumé, giving full background of education and experience and present earnings to Box E. 180.

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